DOCUMENT RESUME

ED 237 692 CE 037 646

TITLE The Prospects for Unemployment and Inflation. Hearing before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, House of Representatives, Ninety-Eighth Congress, First Session.

INSTITUTION Congress of the U.S., Washington, D.C. House Committee on Banking, Finance and Urban Affairs.

PUB DATE 1 Jun 83

NOTE 116p.; Parts of this document may not reproduce well due to small print.

PUB TYPE Legal/Legislative/Regulatory Materials (090) -- Viewpoints (120)

EDRS PRICE MF01/PC05 Plus Postage.

DESCRIPTORS Career Education; *Federal Government; *Government Role; Hearings; *Inflation (Economics); *Monetary Systems; *Public Policy; *Unemployment

IDENTIFIERS Congress 98th

ABSTRACT

This report of a hearing before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs, House of Representatives provides information on unemployment and prospects for employment. The report focuses on the role of the Federal Reserve and actions the administration and Congress must take to bring down unemployment to ensure a successful economic recovery. Testimony includes statements by and additional information submitted for the record by the president of the Federal Reserve Bank of Chicago and the vice chairman of the Board of Governors of the Federal Reserve System, as well as articles from the Wall Street Journal and Dun's Business Month. (YLB)

****
* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *
****

THE PROSPECTS FOR UNEMPLOYMENT AND INFLATION

ED237692

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

JUNE 1, 1983

Serial No. 98-31

Printed for the use of the Committee on Banking, Finance and Urban Affairs

U.S. DEPARTMENT OF EDUCATION
NATIONAL INSTITUTE OF EDUCATION
EDUCATIONAL RESOURCES INFORMATION
CENTER (ERIC)

- This document has been reproduced as received from the person or organization originating it.
- Minor changes have been made to improve reproduction quality.

- Points of view or opinions stated in this document do not necessarily represent official NIE position or policy.

CE037646

U.S. GOVERNMENT PRINTING OFFICE
22-977 O WASHINGTON : 1983

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

FERNAND J. ST GERMAIN, Rhode Island, *Chairman*

HENRY B. GONZALEZ, Texas
JOSEPH G. MINISH, New Jersey
FRANK ANNUNZIO, Illinois
PARREN J. MITCHELL, Maryland
WALTER E. FAUNTROY, District of Columbia
STEPHEN L. NEAL, North Carolina
JERRY M. PATTERSON, California
CARROLL HUBBARD, Jr., Kentucky
JOHN J. LaFALCE, New York
NORMAN E. D'AMOURS, New Hampshire
STAN LUNDINE, New York
MARY ROSE OAKAR, Ohio
BRUCE F. VENTO, Minnesota
DOUG BARNARD, Jr., Georgia
ROBERT GARCIA, New York
MIKE LOWRY, Washington
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
BILL PATMAN, Texas
WILLIAM J. COYNE, Pennsylvania
BUDDY ROEMER, Louisiana
RICHARD H. LEHMAN, California
BRUCE A. MORRISON, Connecticut
JIM COOPER, Tennessee
MARCY KAPTUR, Ohio
BEN ERDREICH, Alabama
SANDER M. LEVIN, Michigan
THOMAS R. CARPER, Delaware
ESTEBAN E. TORRES, California

CHALMERS P. WYLIE, Ohio
STEWART B. McKINNEY, Connecticut
GEORGE HANSEN, Idaho
JIM LEACH, Iowa
RON PAUL, Texas
ED BETHUNE, Arkansas
NORMAN D. SHUMWAY, California
STAN PARRIS, Virginia
BILL McCOLLUM, Florida
GEORGE C. WORTLEY, New York
MARGE ROUKEMA, New Jersey
BILL LOWERY, California
DOUG BEREUTER, Nebraska
DAVID DREIER, California
JOHN HILER, Indiana
THOMAS J. RIDGE, Pennsylvania
STEVE BARTLETT, Texas

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

WALTER E. FAUNTROY, District of Columbia, *Chairman*

STEPHEN L. NEAL, North Carolina
DOUG BARNARD, Jr., Georgia
CARROLL HUBBARD, Jr., Kentucky
BILL PATMAN, Texas
BUDDY ROEMER, Louisiana
BRUCE A. MORRISON, Connecticut
JIM COOPER, Tennessee
THOMAS R. CARPER, Delaware

GEORGE HANSEN, Idaho
RON PAUL, Texas
BILL McCOLLUM, Florida
BILL LOWERY, California
JOHN HILER, Indiana

HOWARD LEE, *Staff Director*

CONTENTS

STATEMENTS

	Page
Keehn, Hon. Silas, president, Federal Reserve Bank of Chicago	27
Martin, Hon. Preston, Vice Chairman, Board of Governors of the Federal Reserve System	7

ADDITIONAL INFORMATION SUBMITTED FOR THE RECORD

Fauntroy, Chairman Walter E.:	
Opening statement	3
Subcommittee's news release, dated May 25, 1983	4
Keehn, Hon. Silas, prepared statement	33
Martin, Hon. Preston:	
Prepared statement	12
Response to request for additional information from:	
Congressman Jim Cooper	75
Congressman Thomas R. Carper	94
Congressman John Hiler	66
The Fed Shouldn't Dwell on Joblessness," Wall Street Journal article of May 9, 1983, by Herbert Stein, submitted by Congressman John Hiler	6
"What Is 'Full Employment'?", article, Dun's Business Month, February 1983	109

THE PROSPECTS FOR UNEMPLOYMENT AND INFLATION

WEDNESDAY, JUNE 1, 1983

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
Washington, D.C.

The subcommittee met, pursuant to call, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Representatives Fauntroy, Barnard, Cooper, and Hiler.

Chairman FAUNTROY. The subcommittee will come to order.

Our hearing today deals with an issue with which we should all be deeply and constantly concerned: Unemployment and the prospects for employment. In April, more than 11.3 million Americans were without jobs, 1.9 million workers were working part time instead of full time, and 1.8 million people had dropped out of the job market. The May figures that will come out next Friday will probably show little improvement.

Tragic as these figures are, they actually understate the serious levels of unemployment afflicting certain areas and groups of our Nation. In States like Michigan, Illinois, and Indiana—the industrial midwest—the unemployment rate has been as high as 17 percent. The unemployment situation is even worse in the black community where the unemployment rate is 18.5 percent. While there has been some improvement in the economy, many economists are projecting that unemployment will remain high even after this recovery has been deemed a success, establishing a new, higher baseline of joblessness in this country.

One cannot exaggerate the social and personal costs of this situation; the loss of valuable job experiences, especially for young people who cannot find jobs; the loss of self-respect and hope among older workers; the strains on families; the deteriorations in physical and mental health, and even the suicides and deaths. We cannot afford policies that prolong unemployment. We need policies to bring about a sustained recovery and millions of new jobs.

Monetary policy will be critical to the strength and duration of the recovery. By itself, it cannot bring about a sustained recovery, especially when this administration's fiscal and social policies are so fundamentally unbalanced and misdirected. Monetary policy should also be concerned with inflation. Nonetheless, a monetary policy which is too timid or too fearful of future inflation will hobble or even prevent a recovery. I expect our witnesses today to

tell us the role the Federal Reserve will play, and what actions they believe must also be taken by the administration and Congress, to bring down unemployment and assure a successful economic recovery.

I also hope that our witnesses can give us a better understanding of the changing nature of our industrial heartland, the changing needs of our work force, the credit requirements of reviving companies, and whether these companies will return to their previous high levels of employment in the aftermath of this economic cycle.

To testify on these questions, we have with us today the Honorable Preston Martin, Vice Chairman of the Federal Reserve Board, and the Honorable Silas Keehn, president of the Federal Reserve Bank of Chicago. Mr. Martin will address the prospects for unemployment on the national level, and Mr. Keehn will testify on the unemployment conditions and prospects in the Chicago Federal Reserve District, which includes all or part of Illinois, Indiana, Iowa, Michigan, and Wisconsin. Both Mr. Martin and Mr. Keehn are members of the Federal Open Market Committee, and will also discuss what the Federal Reserve can do and is doing to reduce unemployment.

[Chairman Fauntroy's opening statement and the subcommittee's news release dated May 25, 1983, regarding Federal Reserve officials testifying on unemployment and inflation prospects, follow:]

OPENING STATEMENT OF THE HONORABLE WALTER E. FAUNTROY
CHAIRMAN, SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

at Hearings on

THE PROSPECTS FOR UNEMPLOYMENT AND INFLATION

Wednesday, June 1, 1983 -- 2:00 P.M.
2128 Rayburn House Office Building, Washington, D.C.

Our hearing today deals with an issue with which we should all be deeply and constantly concerned: unemployment and the prospects for employment. In April, more than 11.3 million Americans were without jobs, 1.9 million workers were working part-time instead of full-time, and 1.8 million people had dropped out of the job market. The May figures that will come out next Friday will probably show little improvement.

Tragic as these figures are, they actually understate the serious levels of unemployment afflicting certain areas and groups of our nation. In states like Michigan, Illinois, and Indiana -- the industrial midwest -- the unemployment rate has been as high as 17%. The unemployment situation is even worse in the black community, where the unemployment rate is 18.5%. While there has been some improvement in the economy, many economists are projecting that unemployment will remain high even after this recovery has been deemed a success, establishing a new higher baseline of joblessness in this country.

One cannot exaggerate the social and personal costs of this situation: the loss of valuable job experiences, especially for young people who cannot find jobs; the loss of self-respect and hope among older workers; the strains on families; the deteriorations in physical and mental health; and even the suicides and deaths. We cannot afford policies that prolong unemployment; we need policies to bring about a sustained recovery and millions of new jobs.

Monetary policy will be critical to the strength and duration of the recovery. By itself, it cannot bring about a sustained recovery, especially when this Administration's fiscal and social policies are so fundamentally unbalanced and misdirected. Monetary policy should also be concerned with inflation. Nonetheless, a monetary policy which is too timid or too fearful of future inflation will hobble or even prevent a recovery. I expect our witnesses today to tell us the role the Federal Reserve will play, and what actions they believe must also be taken by the Administration and Congress, to bring down unemployment and assure a successful economic recovery.

I also hope that our witnesses can give us a better understanding of the changing nature of our industrial heartland, the changing needs of our workforce, the credit requirements of a reviving companies, and whether these companies will return to their previous high levels of employment in the aftermath of this economic cycle.

To testify on these questions, we have with us today the Honorable Preston Martin, Vice Chairman of the Federal Reserve Board, and the Honorable Silas Keehn, President of the Federal Reserve Bank of Chicago. Mr. Martin will address the prospects for unemployment on the national level, and Mr. Keehn will testify on the unemployment conditions and prospects in the Chicago Federal Reserve District, which includes all or part of Illinois, Indiana, Iowa, Michigan, and Wisconsin. Both Mr. Martin and Mr. Keehn are members of the Federal Open Market Committee, and will also discuss what the Federal Reserve can do and is doing to reduce unemployment. Gentlemen, welcome.

WALTER E. FAUNTROY, D.C., CHAIRMAN
STEPHEN L. NEAL, N.C.
DOUG BARNARD, JR., GA.
CARROLL HUBBARD, JR., KY.
BILL PATMAN, TEX.
BUDDY ROEMER, LA.
BRUCE A. MORRISON, CONN.
JIM COOPER, TENN.
THOMAS R. CARPER, DEL.

GEORGE HANSEN, IDAHO
RON PAUL, TEX.
BILL McCOLLUM, FLA.
BILL LOWERY, CALIF.
JOHN HILER, IND.

H2-109 ANNEX NO. 3
WASHINGTON, D.C. 20515
(202) 226-7315

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-EIGHTH CONGRESS
WASHINGTON, D.C. 20515

news release

WEDNESDAY, MAY 25, 1983
FOR IMMEDIATE RELEASE

contact: Howard Lee
Andrew Bartels
202-226-7315

FED OFFICIALS TO TESTIFY ON UNEMPLOYMENT PROSPECTS;
FAUNTROY SUBCOMMITTEE TO HOLD HEARINGS ON UNEMPLOYMENT AND INFLATION

(WASHINGTON, D.C.) Congressman Walter E. Fauntroy (D.-D.C.), Chairman of the Subcommittee on Domestic Monetary Policy of the House Banking Committee, today announced hearings on unemployment and inflation prospects, with Federal Reserve Board Vice Chairman Preston Martin and Chicago Federal Reserve Bank President Silas Keehn as witnesses. These oversight hearings will explore what the Federal Reserve expects unemployment and employment will be in the months ahead, and what it is doing and should do to bring about a strong recovery and lower unemployment. The hearings will be held at 2:00 P.M. on Wednesday, June 1, 1983, in Room 2222 of the Rayburn House Office Building in Washington, D.C.

"Monetary policy can have a powerful and at times devastating effect on unemployment and jobs," Mr. Fauntroy said. "We must assure that the Federal Reserve is at least as conscious of and concerned about the employment consequences of what it does as it is with the inflation consequences. With more than 11 million Americans out of work, we cannot afford a monetary policy that does not give high priority to reducing unemployment. Our hearing will provide us with the opportunity to find out from Preston Martin, Vice Chairman of the Federal Reserve Board, what the Fed is forecasting in terms of unemployment and inflation, and what it is doing to bring down unemployment as well as inflation. It will also give us the opportunity to find out from Silas Keehn, President of the Federal Reserve Bank of Chicago, what employment prospects are in the industrial midwest, one of the areas hardest hit by this recession."

Chairman FAUNTROY. Gentlemen, welcome. We are extremely pleased to have you at this most propitious moment in our country's effort to recover economically. I am going to yield at this time to my distinguished colleague, Mr. Hiler, for a brief comment.

Mr. HILER. I thank the chairman for yielding and wish to applaud him for holding these hearings. In fact, the entire series of hearings we have had this year concerning the relationship of monetary policy to the economic well-being of our country.

This particular hearing today on unemployment, I think, is most appropriate because, after all, real economic growth and lower unemployment are two goals that we all share, even if we may differ on the best way to get there.

In that regard, I would like to submit for the record, Mr. Chairman, if I might, an article that appeared in the Wall Street Journal, Monday, May 9, 1983, by Herbert Stein.

Chairman FAUNTROY. Without objection, so ordered.

[The article referred to follows:]

THE WALL STREET JOURNAL, MONDAY, MAY 9, 1983

The Fed Shouldn't Dwell on Joblessness

By Herbert Stein

Recent discussion of monetary policy between the Federal Reserve and the Democratic members of Congress raises fundamental issues. Steps toward an agreement could lead to a significant improvement of economic policy.

I interpret the congressmen as saying something like the following to the Fed:

"Congress has given you a large grant of power. We want to know what you intend to do with it. We think we are entitled to know in advance so that we can express an opinion of your intentions. We are entitled to have a standard by which to judge your performance. People in the private sector are entitled to know your intentions so that they can make their own best-informed judgment about the course of the economy.

"For some time you have been describing your intentions in terms of targets for the rate of growth of the money supply. That was some improvement over earlier practice, but not much. You gave us targets for several definitions of the money supply, and each target was expressed as a fairly wide range. Any one of several monetary policies could be consistent with bringing at least one of the money supplies somewhere within its target range. Moreover, you gave us your money-supply targets for only one year at a time. Many of the consequences of monetary policy depend on the course of the money supply over several years. Private citizens make economic decisions on the basis of expectations stretching over more than one year and the federal government budgets for a five-year period. So it is important to know your plans for a period longer than one year.

'Relation Is Uncertain'

"Now you have told us that you will be even freer than usual about changing your money-supply targets or departing from them, because the relation between the money supply and economic behavior is now exceptionally uncertain. But you haven't told us by what standards or on the basis of what information you would depart from your money-supply targets.

"To correct our uncertainties about your intentions, we would like to know your objectives for real GNP, nominal GNP, unemployment and inflation for the next four years."

The Fed has usually resisted this idea. I interpret the Fed as traditionally saying the following:

"Monetary policy cannot deliver the objectives you are asking us to specify. A determined effort to reach long-range targets for these variables would prevent the Fed from achieving the best results possible in emerging circumstances. We would certainly fail to meet some of the targets, and this would expose the Fed not only to undeserved criticism but also to unwarranted interference. Congress would be tempted to set its own targets, overriding ours, and this would defeat the long-standing principle that monetary policy should be insulated to some degree from political forces."

In my opinion, the congressional Democrats and the Fed are each right, up to a point. The heart of the matter is the distinction between targets appropriate for the Federal Reserve and those that are not, between objectives the Fed can reasonably be expected to achieve in the long run, subject to some margin of error, and those it cannot. The Fed can reasonably be expected to achieve *nominal* targets—that is, targets expressed in dollars, of which the most important are the price level and nominal GNP. It cannot reasonably be expected to achieve *real* targets—that is, targets expressed in quantities like employment, unemployment or real output.

In his April 12 testimony before the House Committee on Banking, Finance and Urban Affairs, Federal Reserve Chairman Paul Volcker emphasized the distinction between real and nominal targets and invited further discussion.

The Fed operates with nominal instruments—that is, with the dollar amount of bank reserves and with the dollar amount of the money supply. With these nominal instruments it can control other nominal aggregates—the value of output in dollars and the price level in dollars. It cannot control them precisely or over short intervals, quarter by quarter or even year by year, but it can control them well enough over a relevant period. The long-run relationship of the money supply, nominal GNP and the price level are well established, and provide the best guide to monetary policy.

The behavior of the nominal variables does affect the real variables, but indirectly and often perversely. In the short run, an increase in the rate of growth of nominal GNP will increase output and employment until price and wage increases catch up; a reduction in the rate of growth of nominal GNP will reduce output and unemployment until price and wage increases slow down. That is the disinflationary process we are currently experiencing. But the effort to target real variables by monetary policy won't influence, or at least won't improve, the performance of the real variables in the long run. This effort involves a futile—and therefore probably destabilizing—effort to outguess real cyclical fluctuations. And the natural political tendency to set the real targets, especially the unemployment target, at too ambitious a level, encourages inflationary measures in an attempt to reach the targets. The long-term effect of such a policy is probably to reduce the growth of real output by increasing instability and inflation.

The heavy emphasis on real targets—unemployment and output—among the goals of the Federal Reserve has been a major source of inflation and other economic difficulties. For this the Fed hasn't been solely or even mainly to blame. The Fed was only conforming to the thinking that was common in the administration, Congress, the economics profession and the country generally.

But the past 20 years should have taught us to reject this line of thinking. That is why the pending congressional resolutions, which would require the Fed to specify its targets, should be purged of references to employment, unemployment and real GNP. This will, of course, seem shocking to the authors of this proposed legislation, but the shock is needed to divert monetary policy from a potentially ruinous path. Omitting the real variables from the Fed's objectives wouldn't deny their importance; it would recognize that monetary policy contributes most to healthy employment and output by maintaining a low and predictable inflation rate.

A Big Leap

On the other hand, the Fed should not shrink from stating its objectives for the nominal variables—the inflation rate and nominal GNP. That would help explain why the money-supply targets are what they are, why the Fed operates as it does within the target ranges or departs from them and where monetary policy will be aiming beyond the year for which money-supply targets are specified. The public and Congress have a legitimate claim to know the Fed's intentions. Until the Fed commits itself more durably and precisely to objectives for these variables, the fear of recurrent inflation will persist. (The persistence of that fear is evident in financial markets today.)

For the Fed to accept the idea of specifying nominal targets would be as big a leap as for Congress to abandon the idea of specifying real targets. But without this agreement we will face continued uncertainty and variability of monetary policy, legislated commitment to unachievable and inflationary targets, or both.

Board of Contributors

The long-term effect of setting unemployment targets is probably to reduce the growth of real output by increasing instability and inflation.

Mr. Stein is the A. Willis Robertson professor of economics at the University of Virginia, a senior fellow at the American Enterprise Institute, former chairman of the Council of Economic Advisers under Presidents Nixon and Ford and a member of the Journal's Board of Contributors.

Mr. HILER. I thank the Chairman. I look forward to this hearing.

Chairman FAUNTROY. I thank you. I acknowledge the presence also of our colleague, Mr. Barnard.

Mr. Martin, we are very pleased to have you. You may proceed. We have your statement in hand.

STATEMENT OF HON. PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MARTIN. Thank you, Mr. Chairman.

I would ask the indulgence of the committee to enter into the record the complete statement which was submitted to the committee at the appropriate time in order to optimize the committee's time.

I will read only portions of my statement and attempt to aid and abet that as I go, being aware of the busy schedule of the chairman and the members.

Chairman FAUNTROY. Without objection, your statement will be entered in its entirety in the record.

Mr. MARTIN. Thank you, Mr. Chairman.

The Federal Reserve is pleased to be called upon to discuss with the committee the present high rate of unemployment.

As the chairman has indicated, and as Congressman Hiler has reiterated in the introduction, today's unemployment situation is worthy of consideration.

The measures which could be and are being employed to bring down the level of unemployment represent a very appropriate objective for consideration at this time.

The chairman has cited the underemployment which exists in our economy—the geographic distribution of unemployment and underemployment. He has indicated that among the minority labor forces the incidence has been particularly severe.

And we at the Federal Reserve certainly share with the committee the concern with regard to the social costs of this persisting high unemployment. Certainly the price in that sense, the social sense, paid by the individual unemployed and their families has been quite high. And, we are aware that monetary policy has a role to play in the overall set of policies dealing with this problem.

We cannot gloss over the extensive strains in the society which the level of unemployment and underemployment has brought forth.

In my view, the Federal Reserve can contribute to alleviating the overall situation on a macroeconomic basis, but there are issues that it cannot address in the establishment of an environment for sustained improvement in economic activity and employment.

At the present time the committee is acutely aware that our economy is emerging from a most trying and difficult period. We seem to overwork the concept of transition, but we certainly continue to go through one.

Throughout the seventies, we were afflicted by the twin evils of decreasing productivity and increasingly virulent inflation, and by the end of the decade they were threatening to undermine our economy in some very fundamental ways.

The underlying inflation rate had accelerated to the double-digit level, stayed there for many quarters, and seemed likely to be higher.

Speculative behavior of various kinds was spreading into the decisionmaking processes of consumers, of savers, of investors, of business firms, and even in the deliberations of this body.

The dollar had weakened considerably in foreign exchange markets, and inflation was beginning to be viewed as a permanent factor in our economy. Inflationary expectations were exerting an increasingly strong hold on our behavior.

The worsening of inflation in this sense and the application of restrictive policies necessary to bring inflation under control ultimately culminated in a prolonged period of economic stagnation and, because inflation had become so deeply embedded in our economy, prices kept rising even in 1980 and 1981 when the economy was falling into recession.

In 1982, however, the application of policies to combat inflation began to bear substantial fruit. The committee is aware of the favorable trends in all the major price indices since 1981, and thus I won't take your time to review those.

It is true that some of our progress against inflation is special, pertaining to agriculture or to energy markets. However, as you are aware, there have been indications of more fundamental gains as the wage-price interactions that had helped perpetuate inflation throughout the 1970's for some time have been losing their momentum.

A slower rate of increase in labor cost is relieving pressures on prices and should have a positive effect on the demand for labor. A slowing of prices is dampening, in a circular way, inflationary expectations and relieving workers' fears of falling behind in an inflationary spiral.

Curbing the momentum of inflation is now beginning to have a salutary effect on real activity that had long been anticipated. The halving of inflation rates during 1982, together with a number of other factors, contributed to substantial declines in interest rates over the second half of last year. As a result, activity began to improve last summer in housing. Gains in consumer spending gained momentum last fall and in recent months, as you know, a broad number of other economic indicators have been pointing toward a further strengthening of our economy. It is noteworthy that barometers of consumer attitudes and of business sentiment have strongly improved, and increases in production and the work week and in sales are now apparent in a wide range of industries.

The price and employment developments since the beginning of the year have been broadly in line with the economic expectations that we reported to you from the members of the Federal Open Market Committee, Mr. Chairman, and which were included in our February monetary policy report. The general thrust of those projections you may recall was that activity and employment were expected to expand at a moderate rate this year, and that the pace of recovery would be consistent with further progress toward price stability. With the recovery apparently gaining momentum in recent months, I believe there is an excellent chance that this

year's economic performance will be at least as good as we projected in mid-February.

The committee knows that at the same time a number of potential obstacles to sustaining this economic growth were apparent in February and are apparent today. Despite the favorable economic developments of the past few months, those obstacles still confront us. Foremost among these is the prospect that Federal budget deficits will persist at very substantial levels in the years ahead, even as the economy moves well into its expansionary stage. The Federal deficit in the current fiscal year, as you know, is expected to exceed 6 percent of GNP and, unless constructive action is taken, this share will remain extremely large in the years ahead.

In part, because of these prospective mega-deficits, intermediate and long-term interest rates remain high, both as to their historical levels and relative to current inflation rates.

And financial markets remain unsettled reflecting concerns that the deficits will keep pressures on interest rates and eventually lead to a renewed surge of price inflation.

To be sure, the task of controlling inflation and restoring growth should not be viewed as a responsibility of monetary policy alone. Fiscal policy too must do its part and I am well aware that this committee, the Congress and the administration, are all sensitive to the dangers of the looming budget deficits. At the same time the events of recent weeks illustrate the great difficulties of reaching and maintaining a consensus on how best to reduce the deficits. While mindful of these difficulties, I would respectfully urge you to continue seeking positive solutions that mitigate the dangers associated with persistent huge structural deficits.

Of course, there are other obstacles to continued economic recovery. The current difficulties in the world economy, a world market into which we have become increasingly integrated in the past decade, is notable. Poor economic conditions in foreign nations as well as a strong dollar have limited U.S. exports in the past 2 years. I would wish to cite a recently released report "Domestic Employment Generated by U.S. Exports" prepared by the Office of Trade and Investment Analysis, U.S. Department of Commerce, which indicates that the number of Americans in export-related jobs declined from 6.2 million in 1980 to 4.9 million in 1982.

What matters most though is not the pace of the recovery in these, its first few months, but whether we can achieve a broad-based and sustained expansion. It is to that end that our current policies must be directed.

Monetary and fiscal policies must necessarily share responsibility for the long run state of the economy, but at the same time we should be fully aware of the particular ways in which monetary policy can influence the economy and of the ways in which monetary policy's influence is limited.

Economic analysis shows rather convincingly, I believe, that monetary policy can be a contributing factor in the rate of growth in nominal income, but there is no certainty that a particular monetary policy will have the intended effect on real economic activity and employment, particularly in the long run.

One of the lessons learned in the past decade is that there is no reliable tradeoff, between inflation and unemployment and, be-

cause the dangers of inflation were neglected far too long, the process of moving back toward a more stable price environment has become quite lengthy and very costly.

We would all agree, I think, that what we want ultimately for our citizens is an environment of rising real incomes and expanding job opportunities.

I am convinced that the best way the Federal Reserve can help achieve that end is by working to establish the kind of noninflationary economic expansion that can be sustained for a long period. Given an economy in which there is confidence of continued price stability, a steady rise in employment and in living standards is likely to follow.

There remain, Mr. Chairman, the difficult questions of the extent to which the present recovery might reduce unemployment and, conversely, to the extent to which "structural," as well as "frictional," unemployment would still persist even when the economy has returned to its long-run non-inflationary growth path.

The concept of structural unemployment is obviously a useful one in this regard.

Structural unemployment has long been a problem, as the committee chairman has indicated, for certain groups who often lack the training needed in a rapidly changing labor force. But, structural unemployment also arises as patterns of labor demand shift in response to changing population patterns, technological advances, and increased competitiveness in international markets.

Typically these structural changes occur gradually with diminished employment in some regions and industries being offset by expansion of job opportunities in other areas.

Occasionally, though, it is speeded up, as it appears to in recent quarters. Because it takes time for dislocated workers to obtain new training, as Congressman Hiler indicated, and to revise wage expectations, the spells of unemployment for these workers tend to be particularly long.

Unfortunately, monetary and fiscal policies are ill-equipped to deal with the special problems of structural unemployment. However, over time a number of programs have evolved to address the difficulties of the structurally unemployed.

The approaches taken are well known. They have included training, educational programs, relocation assistance, income maintenance, and special job creating policies.

We are still learning whether some of these approaches, when carefully crafted to encompass the cooperative actions of business, labor, government, including State and local government, can contribute to a real easing of the unemployment problems that confront us.

A particular challenge for the period ahead will be to adapt these several approaches so as to best aid those workers displaced by the rapid changes now occurring in our industrial and services sectors.

In conclusion, Mr. Chairman, monetary policy best serves by continuing to be focused on fostering a lasting expansion in business activity within the framework of continued progress against inflation.

At the same time, we recognize fully our responsibilities in promoting safety and soundness in financial institutions and in the financial markets, and in supporting a strengthening of the international financial system on which so much of our export jobs depend.

This Nation has experienced this most difficult adjustment process of restructuring for a more productive, less inflationary economy, after a decade of low productivity and destructive inflationary pressures. The human and economic costs of this disinflationary process have been high. We cannot step back now from our commitments and thus jeopardize the gains we have garnered to date. The health and sustainability of the economic recovery depends, of course, on monetary policy, but also on fiscal policy, in particular on whether policymakers can reduce the dangers of massive out-year budget deficits.

With a responsible fiscal policy to complement the monetary policies now in place, I am confident that the recovery can prove a durable one associated with rising living standards and increased employment.

Thank you, Mr. Chairman.

Chairman FAUNTROY. Thank you, Mr. Martin.

[The prepared statement of Mr. Martin follows:]

Statement by

Preston Martin

Vice Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance, and Urban Affairs

U.S. House of Representatives

June 1, 1983

I am pleased to have this opportunity to discuss the current employment situation, which, quite rightly, is a matter of great concern both to the members of this committee and to the Federal Reserve. As you are well aware, the nation's unemployment rate reached a postwar high during the recent recession; and although labor demand is now strengthening, one-tenth of our labor force was still unemployed when the most recent labor market surveys were conducted in mid-April. Similar problems of high unemployment characterize our trading partner nations because of a long period of slow growth in the world economy.

This recent period of high unemployment has disrupted the lives of millions of willing workers and their families. Many persons who held jobs have lost them in the wake of declining economic activity. Others, seeking jobs for the first time, have been unable to find them, and have instead fallen into the ranks of the unemployed. Still others, discouraged by poor labor market conditions, have dropped out of the labor force altogether.

Obviously, an employment situation like this creates extensive strains within our society. We can point with considerable pride to our success in reducing inflation over the last two years. However, that gain would represent only a partial success if it were to leave a large part of our workforce outside the mainstream of economic life for

22-977 O - 83 - 2

extended periods. Therefore, we at the Federal Reserve share this committee's interest in exploring the dimensions of the current employment situation and in seeking ways in which it might be constructively addressed. In my remarks today I will focus on the broad dimensions of the economic situation, particularly as it affects labor markets, and will indicate what, in my view, the Federal Reserve can do--and cannot do--to help establish a climate for sustainable improvement in economic activity and employment. My colleague, Mr. Silas Keehn, President of the Federal Reserve Bank of Chicago, will then focus on the particular employment problems of several of the states within his Reserve Bank's district.

At the present time our economy is emerging from a most trying and difficult period. Throughout the 1970s we were afflicted by an increasingly virulent inflation that, by the end of the decade, was threatening to undermine our economy in rather fundamental ways. The underlying inflation rate had accelerated to the double-digit level and seemed likely to go higher. Price speculation was spreading into the decision-making processes of both businesses and consumers, and the dollar had weakened considerably in foreign exchange markets. An even more troubling development was that high inflation was coming to be viewed as a permanent feature of our economy; more and more, inflation was being built into the structure of interest rates, and rising inflationary

expectations were exerting an increasingly strong hold on the behavior of savers and investors alike.

This gradual worsening of inflation, and the application of restrictive policies necessary to bring inflation under control, eventually culminated in a prolonged period of economic stagnation. On balance, from mid-1979 to late 1982, there was little change in real output, and our economy fell substantially beneath its potential to produce. In labor markets the total number of unemployed workers rose by 5-1/2 million from late 1979 to the end of 1982, and the unemployment rate reached a maximum of 10.8 percent, about 5 percentage points above the lowest point reached during the economic expansion of the late 1970s.

The long period of economic stagnation and rising unemployment affected most industries, regions, occupations, and demographic groups. The most serious impact, however, was felt by the cyclically sensitive construction and durable goods manufacturing industries, many of which already were facing difficult transitions because of heightened competition from foreign producers. In some key sectors--including steel, autos, and lumber--operating rates fell to extremely low levels, and economic hardships became widespread in the communities that were dependent on these industries. Unemployment rose especially rapidly among adult men, who hold a disproportionate number of jobs in the durable goods producing industries. Among blacks and teenagers, unemployment rose

further from rates that already were far above the national average. As the period of economic recession became more prolonged, the number of long-term unemployed rose to an exceptionally high level.

At the same time, despite a discouraging labor market situation overall, there continued to be signs of underlying employment stability in several sectors--and even a few pockets of vitality--as the rapid growth of new industries led to expanding job opportunities. For example, the service sector of the economy continued to grow throughout the recession and now employs 1-1/2 million more people than it did at the beginning of 1980. Over that period, the use of computers in our economy increased especially rapidly, and the number of workers providing computer and data processing services, though still a small share of total employment, has risen by more than a fourth in the past three years.

Because inflation had become so deeply embedded in our economy, prices kept rising rapidly in 1980 and 1981, even as the economy was falling into recession. Inflation in 1980 remained near the double-digit level, and in 1981 the slowing of prices was mainly confined to a few sectors of the economy.

In 1982, however, the application of policies to combat inflation began to bear substantial fruit. The slowing of price advances became more widespread and potentially more

lasting, as all major price indexes advanced at considerably slower rates than in 1981. For some price measures the increases in 1982 were the smallest in more than a decade, and price developments have continued to be quite favorable into early 1983.

It is true that part of that slowdown in inflation reflected the influence of special developments in agricultural and energy markets. However, there have also been strong indications of more fundamental gains, as the wage-price interactions that had helped perpetuate inflation through the 1970s began losing their momentum. Many businesses have been adapting their pricing policies to the realities of a more competitive and less inflationary economy. Work rules are changing as firms strive to bolster productivity and trim costs. At the same time, workers are agreeing to smaller pay increases than in earlier years; but, happily, with inflation falling so rapidly, the slowing of nominal wage increases generally has been consistent with gains in real purchasing power. A slower rate of increase in labor costs is relieving pressures on prices, and in turn a slowing of prices is damping inflationary expectations and relieving workers' fears of falling behind in an inflationary spiral.

For the time being, at least, this cumulative process of disinflation appears to be continuing. Wage adjustments so far this year have been holding at a reduced

pace similar to that of late 1982, and recent price developments have been exceptionally encouraging. The consumer price index rose at about a 2 percent annual rate over the first four months of this year, and the producer price index actually fell at nearly a 4 percent annual rate during that same period. Although these price data were influenced in part by declining oil prices early in the year, they also are indicating a continued easing in underlying inflationary trends.

Curbing the momentum of inflation is now beginning to have the salutary effects on real activity that had long been anticipated. The halving of inflation rates during 1982, as well as a number of other factors, contributed to substantial declines in interest rates over the second half of last year. As a result, activity began to improve last summer in housing; gains in consumer spending started to appear last fall; and in recent months a broad number of other economic indicators have been pointing to a strengthening economy. Barometers of consumer attitudes and business sentiment are strongly improved, and increases in production and sales are now apparent in a wide range of industries.

The upturn in economic activity has, in turn, led to some firming of labor market conditions. The rate of layoffs began slackening in late 1982, and the unemployment rate has started to come down from its peak level. Total payroll employment has increased by about 650,000 since the

end of last year, with more than one-third of those gains coming in the manufacturing sector, in which employment had previously declined steadily for a year and a half. So far, the gains have been about average for the early stages of a recovery.

The price and employment developments since the beginning of the year have been broadly in line with the economic expectations held by members of the Federal Open Market Committee and included in our February monetary policy report to the Congress. The general thrust of those projections, you may recall, was that activity and employment were expected to expand at a moderate rate this year and that the pace of the recovery would be consistent with further progress toward price stability. With the recovery apparently gaining momentum in recent months, I believe that there is an excellent chance that this year's economic performance will be at least as good as was projected in mid-February.

At the same time, a number of potential obstacles to sustained economic growth were apparent when the monetary policy report was prepared, and despite the favorable economic developments of the past few months, those obstacles still confront us today. Foremost among these is the prospect that Federal budget deficits will persist at very substantial levels in the years ahead, even as the economy moves well into an expansion. The federal deficit in the current fiscal

year is expected to exceed 6 percent of GNP, and unless constructive action is taken, this share will remain extremely large in the years ahead. In part because of these prospective mega-deficits, intermediate and long-term interest rates remain high relative both to their historical levels and relative to current inflation rates, and financial markets remain unsettled, reflecting concerns that the deficits will keep pressures on interest rates and eventually lead to a renewed surge of price inflation.

Concern about a budget-induced resurgence of inflation is symptomatic of a more widespread and still persistent fear that inflation has been brought under control only temporarily and that it will escalate again once a new expansion has gained momentum. To a considerable extent, that fear arises from more than a decade of failed efforts to reduce inflation for more than brief periods; and because such expectations of inflation are still very much in evidence, we must be especially prudent in designing monetary policy in the period ahead. In particular, focusing monetary policy solely on the need for rapid growth and ignoring the still-present threat of inflation would risk surrendering the gains that we have made against inflation at such a high social cost.

To be sure, the task of controlling inflation and restoring growth should not be viewed as the responsibility

of monetary policy alone. Fiscal policy, too, must do its part. I am well aware that Congress and the Administration are sensitive to the dangers of the looming budget deficits; but at the same time the events of recent weeks illustrate the great difficulties of reaching a consensus on how best to reduce these deficits. While mindful of these difficulties, I would strongly urge you to continue seeking positive solutions that mitigate the dangers associated with persistent, huge structural deficits.

Other obstacles to an economic recovery reflect current difficulties in the world economy, into which we have become increasingly integrated in the past decade. Poor economic conditions in foreign nations, as well as a strong dollar, have limited U.S. exports in the past two years and have contributed importantly to the loss of jobs in several of our basic industries. This external drag on our economy, if it were to continue, would be an impediment to renewed expansion in the U.S. economy. Perhaps an even more serious development is that the prolonged period of slow growth worldwide has exacerbated debt-servicing problems in the developing nations and is causing a rise in protectionist sentiment in the industrial nations. The dangers inherent in this world economic situation are substantial; but they are not insurmountable, and I remain hopeful that we can deal with them successfully through the cooperative efforts of private and public institutions.

So long as we make progress toward solving these difficulties, both at home and in the international arena, the most likely outcome for our economy will be that of expanding activity and declining unemployment. Those gains, of course, may not be steady from month to month and will not show up evenly in all sectors. Indeed, because of the stresses and uncertainties spawned by many years of high inflation and slow growth, many businesses will likely be hesitant to expand investment and employment until there are more convincing signs that the recovery will prove lasting. Unemployment, therefore, will probably still be at a high level at the end of this year.

What matters most, though, is not the pace of the recovery in its first few months, but whether we can achieve a broad-based and sustained expansion; and it is to that end that our current policies must be directed. Monetary and fiscal policies must necessarily share responsibility for the long run state of the economy, but at the same time we should be fully aware of the particular ways in which monetary policy can influence the economy and of the ways in which its influence is limited.

Economic analysis shows rather convincingly, I believe, that monetary policy can be a contributing factor determining the rate of growth in nominal income, but that there is no certainty that a particular monetary policy

will have the intended effect on real economic activity and employment, particularly in the long run. One of the lessons learned in the past decade is that there is no reliable trade-off between inflation and unemployment, and because the dangers of inflation were neglected far too long the process of moving back toward a more stable price environment has become quite lengthy and very costly.

We would all agree, I think, that what we want ultimately for our citizens is an environment of rising real incomes and expanding job opportunities. I am convinced that the best way the Federal Reserve can help achieve that end is by working to establish the kind of noninflationary economic expansion that can be sustained for a long period. Given an economy in which there is confidence of continued price stability, a steady rise in employment and in living standards is likely to follow.

There remain, Mr. Chairman, the difficult questions of the extent to which the present recovery might reduce unemployment and, conversely, the extent to which "structural," as well as "frictional," unemployment would still persist even when the economy has returned to its long-run noninflationary growth path.

The concept of structural unemployment is obviously a useful one in that it seeks to identify that portion of total unemployment that is less related to the normal workings of

the business cycle and for which special programs that seek to attain a better match between workers and jobs might prove effective.

Structural unemployment has long been a problem among certain groups--teenagers, for example--who often lack the training needed in a rapidly changing labor force. But, it also arises as patterns of labor demand shift in association with such factors as changing population patterns, technological advances, and the increased competitiveness in international markets. Typically, these structural changes occur gradually, with diminished employment in some regions and industries being offset by an expansion of job opportunities in other areas. Because it takes time for dislocated workers to obtain new training, to relocate, or to revise their wage expectations, the spells of unemployment for these workers tend to be particularly long.

In practice, unfortunately, there has never been a clear-cut analytical or statistical distinction between structural unemployment and cyclical unemployment, and attempting to apply the distinction is especially difficult in the current period. It may well be, for instance, that structural change has occurred at an unusually rapid pace in recent years, and that some industries will continue to fall well short of their previous peak levels of activity, even with a healthy and sustained economic recovery. Presumably, some of the workers displaced

from those industries will discover new employment opportunities in sectors that are expanding, such as the high-technology industries. But such employment shifts take time, and there is legitimate concern about whether the new industries can absorb expeditiously the workers dislocated from declining industries, especially given differences in geographic location and required job skills.

Our historical experience suggests that a portion of today's unemployment problem--probably a sizable portion--can best be alleviated through macroeconomic policies designed to encourage a sustainable recovery in activity, and some of the problems that now appear structural may disappear as activity recovers. Nevertheless, it appears that a significant unemployment problem is likely to persist even in a steadily expanding economy. In the late 1970s, for instance, the unemployment rate dipped only slightly below the 6 percent mark, even after four years of economic expansion, and at present it does not seem likely that the rate will drop back to that level any time soon. Indeed, the difficulties of reducing unemployment in the period ahead may be exacerbated by the deep-seated, and perhaps irreversible, changes that are affecting many of our primary industries.

Unfortunately, monetary and fiscal policies are ill-equipped to deal with the special problems of structural unemployment. However, over time a number of programs have

evolved to address the difficulties of the structurally unemployed. The approaches taken have included training and educational programs, relocation assistance, and special job creating policies. We are still learning whether some of these approaches, when carefully crafted to encompass the cooperative actions of business, labor, and government, can contribute to an easing of the unemployment problems that confront us. A particular challenge for the period ahead will be to adapt these approaches so as to best aid those workers displaced by the rapid changes now occurring in our industrial sector.

In conclusion, Mr. Chairman, monetary policy best serves by continuing to be focused on fostering a lasting expansion in business activity within the framework of continued progress against inflation. At the same time we recognize fully our responsibilities in promoting safety and soundness in the financial markets and in supporting a strengthening of the international financial system. This nation has experienced the difficult adjustment process of restructuring for a productive, less inflationary economy after a decade of low productivity and destructive inflationary pressures. The human and economic costs of this disinflation process have been high. We cannot step back now from our commitments and thus jeopardize the gains that we have garnered to date. The health and sustainability of the economic recovery depends, of course, not only on monetary policy, but also on fiscal policy, in particular on whether policymakers can reduce the dangers of massive out-year budget deficits. With a responsible fiscal policy to complement the monetary policies now in place, I am confident that the recovery can prove a durable one, associated with rising living standards and increased employment.

Chairman FAUNTROY. We will move on to Mr. Keehn's statement, after which we will have questions.

STATEMENT OF HON. SILAS KEEHN, PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO

Mr. KEEHN. Thank you, Mr. Chairman.

A copy of the full text of my statement has been delivered to the committee.

In the interests of saving your time and, if the committee would prefer, I would be pleased to provide a briefer summary of my statement.

Chairman FAUNTROY. If you would do so, it would be appreciated. Your statement in its entirety will be included in the record.

Mr. KEEHN. Thank you very much.

I appreciate the opportunity to appear before the subcommittee today to discuss the prospects for unemployment. I hope that my comments will be useful to this subcommittee in its important deliberations.

The Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, comprising all of Iowa, and major portions of Illinois, Indiana, Michigan, and Wisconsin.

My testimony today will concentrate on this five-State area.

The district has encountered serious economic difficulties for the past 4 years, commencing roughly with the Iranian oil embargo of 1979. Trouble had been building under the surface for a much longer period, but prior to 1979 our region was still generally prosperous. Previous business recessions since World War II impacted the region seriously, but activity always rebounded to new highs in a year or so once a recovery was firmly underway. Since 1979 there have been no sustained recoveries. However, evidence even in our area is steadily accumulating that a durable recovery is now underway.

Trends in unemployment provide our best available indication of the state of economic health in our district. In March, the latest month for which consistent data are available for all of our States, nonfarm payroll employment nationally was 2 percent below March 1982, while in the district it was down 3 percent.

Manufacturing employment was down 6 percent from a year earlier nationally and down 8 percent in the district. Despite some callbacks in the auto and building material industries, total employment has risen only modestly in the district since March and employers offer little hope of a significant upturn in the near future.

The trend of employment is particularly disturbing when viewed over a longer time span. In March nonfarm payroll employment in the United States was 1 percent below March 1979. In the district it was down 10 percent.

From 1947 through 1979 payroll employment increased nationally at a compounded rate of 2.3 percent annually. If this trend had continued, payroll employment, nationally, would be about 9 percent higher currently than in early 1979 rather than 1 percent lower. From 1947 through 1979 employment in the district increased at a 1.7-percent annual rate. If this trend had continued,

employment in the district would be 7 percent higher now rather than 10 percent lower.

Very simply, we have had a negative gap in employment in the Midwest, and with the passage of time the magnitude of the gap has been increasing.

In March unemployment was estimated at 10.3 percent of the labor force nationally and 12.5 percent in the five-State area with a range of from 9.8 percent in Iowa to 15.7 percent in Michigan. All of the data for the individual states for the month of April are not yet available, but in Michigan the unemployment rate in April had declined to 14.9 percent. In early 1979 unemployment was less serious in the district than was the case nationally. Since then the problem has become relatively more serious in our area and substantially so.

Unemployment problems vary by locality. In the past year or two jobless rates have been estimated at 15 to over 20 percent for industrial centers such as Rockford, Ill.; Gary, Ind.; Dubuque, Iowa; Flint, Mich.; and Racine, Wis. Unemployment is chronically high among the minority groups in large cities, especially Chicago and Detroit.

Unemployment is particularly high for teenagers compared to adults and for blacks relative to whites.

One pattern of unemployment, however, has shifted in the past 2 years, both nationally as well as regionally. Historically jobless rates were lower for men than women. Currently jobless rates are higher for men. The main reason is that unemployment has been heaviest and most prolonged in durable goods manufacturing and in construction, sectors where female workers are relatively few.

The current recession has repeated the course of earlier declines with the heaviest layoffs in the most cyclical industries, hard goods manufacturing and construction. The main difference this time is the long duration of the problem coupled with increasing concern that cyclically depressed industries will never fully recover, at least not in the form in which they existed prior to 1979. Many factories in our area have been closed and demolished.

Population in the district has been growing somewhat less rapidly than in the Nation for quite some while. However, in the 1970's this disparity increased. In the period from 1970 to 1980, growth was 11.4 percent for the United States as a whole and 4.2 percent for the five States. From 1980 to 1982, U.S. population rose 2.2 percent while the five-State area declined by 0.3 percent. Indiana, Iowa, and Michigan all lost population in the period between 1980 and 1982. The reduction or reversal of population growth reflects in large part the migration of jobseekers to the south and to the west. Fewer people mean less need for all consumer goods and services including housing. Fewer workers are required to supply these needs when the population grows at a slower pace or declines.

In a large degree, the relative increase in unemployment in the Seventh Federal Reserve District reflects the composition of industry and distribution of employment in the region. In 1978 15.7 percent of the Nation's nonfarm payroll employment was in the five-State area. Somewhat more than its proportion of the Nation's population. That year these States accounted for 19.3 percent of the Nation's employment in manufacturing, and 23.4 percent of em-

ployment in durable goods manufacturing. Within durable goods, these States accounted for much larger proportions of employment in steel, motor vehicles, and equipment for agriculture, construction, metal working, mining, rail transportation, and recreation.

In the past 4 years all of the durable goods industries reduced employment sharply, especially those that are dominant in our district. Moreover, in many cases the district's share of the Nation's employment in these industries declined.

Among the causes, as we view them, are the following: Generally depressed conditions always affect durables more severely, both consumer and producer goods. Reduction in demand has been intensified by high interest rates and increased the cost of financing long-lived equipment. In addition, low farming for 3 successive years has caused farmers to curtail purchases of equipment predominantly manufactured in our district.

The energy crisis has had a particularly severe impact on the district. High fuel costs have deterred outlays on motor vehicles and recreational equipment. Moreover, the district imports most of its fuel from other States and abroad, and it has a relatively small involvement in the apparatus associated with energy development.

Procurement of defense equipment has been expanding rapidly and is expected to rise further. The district's involvement in defense, although significant in some items, is far below its proportion for equipment generally.

The district has also been hurt by the migration of industry to the Sun Belt, encouraged by lower employment costs and lower fuel costs. Some district companies increasingly have concentrated production in their more southern plants.

Increased foreign competition aided by the high value of the dollar and subsidization of industry by foreign government has had more effect on our district than elsewhere in the Nation, especially in the area of steel, vehicles, and capital goods. Foreign producers have much lower labor costs and American technological leads have diminished.

The huge rise in the price of energy since 1973 has had a direct adverse effect on demand for vehicles and other district products that use fuel. There is another dimension to the problem. Per capita energy use in the district is relatively high. This includes fuel for heating homes and other buildings as well as for transportation and for industrial processes.

District States produce only a very small proportion of the fuel that they consume—oil, natural gas, and coal. Illinois has vast underground supplies of high sulfur coal, but the usage has been closely restricted by antipollution regulations. As a result, coal burned by Midwest electric utilities is largely imported from the Rocky Mountain States. Oil and natural gas come mainly from the Southwest and from abroad.

The price of fuel at the source or at ocean ports becomes even higher when transportation costs to the Midwest are added. In addition, energy producing States levy heavy severance taxes on coal, oil and gas production. As a result, fuel users in district States help pay the costs of government in the fuel producing States.

Wage rates in the district have been above average for the Nation for many years. The gap is widest in Michigan where

hourly earnings for production workers in manufacturing in 1982 averaged nearly one-third higher than for the United States. Wage rates in other seventh district States were 10 percent to 18 percent higher than the national average.

In addition to wages, total worker compensation includes benefits such as vacation pay, pensions, medical and dental insurance as well as workmen's compensation, supplementary unemployment benefits, and many other items. These benefit packages tend to be very liberal in durable goods industries as a result of successive improvements obtained in union contracts over the years. In heavily unionized areas such as the Michigan automotive centers, worker compensation in nonunionized industries, such as banking, tend to be influenced by the terms won by unions. Unionization in the district has become increasingly important in State and local government, education, and food retailing.

Productivity growth in district industries—which can offset increases in compensation—has been hampered by a number of factors. Some relate to labor problems such as absenteeism, strikes, restrictive work rules on job assignments, overtime pay and discipline. The district also has a disproportionate share of the Nation's older industrial facilities which compete with newer plants that are located elsewhere. They were planned and constructed at a higher state of the art.

Our five district States contribute a much higher proportion of the Federal Government's revenues than they receive in Federal disbursements. This is especially true in the case of national defense. The district has about 15 percent of the Nation's population, and generates 15 percent of its personal income. But these States receive less than 11 percent of total Federal outlays, and only 5 percent of outlays for defense. The relatively low participation of the district in Federal outlays stands out dramatically in comparison with the other States on a per capita basis.

The five States in our area rank at the very bottom of the 50 States in per capita total Federal spending and near the bottom in terms of defense spending.

Until the late 1970's, increases in State and local government employment in the district had tended to offset periodic declines in private employment, rising even in recession years. In the past 2 years, State and local governments throughout the district have been grappling with serious financial problems. Revenue shortfalls have reflected both the recession's effect on tax revenues and cutbacks of Federal aid. State and local governments are dealing with their financial problems by curtailing programs and raising taxes. While these steps are absolutely necessary to achieve financial solvency, they work to reinforce the problems of the region.

In the past 3 years declining farming has coincided with and reinforced the contraction in manufacturing. Many smaller communities are dependent on sales of equipment, supplies and services to farmers. There are signs that the farm sector also is beginning to recover, but any improvement here is likely to be slow.

The acreage removed from production of major crops this year will be nearly a fifth of the area planted in 1982. The largest removal ever under government programs. The decline in acreage will help return the farm sector to a stronger financial footing. But

in the interim industries that furnish products and services to farms will experience weak sales. Sales of farm equipment will remain at very depressed levels, but may begin to strengthen later in the year.

A large share of unemployment in the district is concentrated in the distressed inner-city areas of the larger centers. Job opportunities of residents are restricted by inadequate education and by other problems associated with disadvantaged groups. High crime rates deter businesses from locating in the inner city and may determine decisions to migrate. Insurance costs are high, because of the risk of damage to property.

Employment growth in the central business districts of large cities has been dampened by a number of other factors, including decentralization of corporate headquarters and automation of financial and other services. Organizations which had been adding workers steadily into the mid-1970's, such as banks, insurance companies, public utilities and government bodies have stabilized or reduced staff in the past year or two. Until the mid-1970's, most of these employers were hiring actively year after year.

Regulations controlling industrial emissions have had a disproportionate impact on the Middle West. Controls can be incorporated at lower cost in newly constructed facilities. Deadlines for meeting emission standards imposed on older plants may be satisfied more easily by simply closing the plants.

Business groups complain of unfavorable business climates in the industrial States of the Midwest. Costs of unemployment insurance and workmen's compensation are relatively high in our area, especially in Illinois and Michigan. Other complaints involve high taxes, State pollution controls, laws affecting hiring and personnel practices, and other regulations.

Some large district companies that were in excellent financial condition a decade ago are now operating under very severe stress. Their problems usually are the result of several factors—falling sales below expectations, intense competition, rising cost of labor and other inputs, and heavy debt incurred at relatively high interest rates. Erosion of morale and confidence which has been developed over the past several years will not be corrected in the next year or two. Until financial strength is solidly re-established and the general economy is clearly in a new growth trend, business caution will restrain commitments for new capital spending, inventory investment and hiring.

Projections of employment and unemployment are subject to very substantial error. The main factor affecting conditions in the Midwest in the future will be the trend of the national economy. A strong and sustained recovery would eventually bring sharply higher orders for districts' capital goods. However, most of the adverse factors described above can be corrected only gradually. Many manufacturing operations that were closed in recent years will never reopen, and some of the service industries, for example, financial futures and the like, are growing steadily, but this will not replace a vigorous manufacturing sector.

In the long run, we believe the Midwest can regain its economic health, although not in the same robust form as earlier decades. Adjustments in business, agriculture, labor, and government are al-

ready underway. The present resources that brought prosperity to the region are still present, such as excellent transportation, ready access to raw materials and markets, ample fresh water, a well-educated work force, and a highly productive agricultural hinterland. A major precondition for sustained economic growth and reduced unemployment in the Nation, and especially in our area, is the maintenance of a noninflationary environment. A resurgence of inflation would recreate the distortions in business and individual decisionmaking that were associated with ever higher rates of unemployment and successive business cycles.

I emphasize the importance of price stability, because the economic problems of the Midwest are traceable to a very large degree to inflation. For many years inflation nurtured an illusion of economic well-being while cutting deeply into the regions' economic strength. Inflation is accompanied by increases in operating costs, costs of carrying inventory, and capital investment. If rising costs are not fully reflected in increased selling prices, real profits then decline.

Lenders, fearful of the erosion of their investments through inflation, insist on shorter maturities. Long-term funds become less available, and borrowers with long-term horizons are less able to undertake investments. Cutoff rates of return are raised and corporations look for investments with shorter paybacks. Purchasers of existing assets may appear preferable to financing new plant and equipment.

With a large proportion of its manufacturing employment in durable goods, our district has been hard hit by the sluggishness of new investment. A noninflationary environment will revitalize long-term financial markets, increase incentives for investment and greatly improve the employment outlook. The recoveries has started, but painful adjustments are still underway. We must be aware of pressures to speed the up trend by excessive expansion of money and credit, and still heavier Federal deficits.

Short-term improvement induced by inflationary economic policies would cause severe long-term losses. Price stability fostered by appropriate monetary policy is a necessary condition of the reduction of both inflation and unemployment.

There is also a role for the individual Reserve banks. The complex processes of economic adjustment involves social and economic objectives that may conflict and goals of various regions that may clash. Cooperative national and regional efforts are required. The Reserve banks can assist in this process, serving the centers for studies of the regions and as catalysts for cooperative efforts.

Mr. Chairman, that concludes my statement. I do appreciate the invitation to testify here and, also, most importantly, in your interest of the problems of our particular district.

[The prepared statement of Mr. Keehn follows:]

Statement by

Silas Keehn

President, Federal Reserve Bank of Chicago

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

June 1, 1983

I appreciate the opportunity to appear before this Subcommittee today to discuss prospects for unemployment. The severity of the current economic difficulties in the Midwest and the concerns about the longer-term problems associated with economic adjustment have been widely reported and discussed. Nevertheless, it seems to me that the seriousness of the situation requires all of us, in both our official and private capacities, to do all we can to find realistic and economically justified resolutions of the problems of insuring sustainable high levels of economic well-being both in our region and nationwide. I hope that my comments will be useful to this Subcommittee in its deliberations.

The Federal Reserve Bank of Chicago, of which I am President, serves the Seventh Federal Reserve District comprising all of Iowa and the major portions of Illinois, Indiana, Michigan, and Wisconsin. While we often refer to the region of the Seventh District as the "Midwest," we have no monopoly on this term. "Midwest" is often applied to the entire area north of the Ohio River from the Appalachians to the Rockies, or to the Bureau of Census' designated North Central states, divided into the East North Central region (five states) and the West North Central region (seven states). (See map)

The problems of western Pennsylvania and Ohio have been broadly similar to those of the states of the Seventh District. However, my testimony will concentrate on the five-state area with which we are most familiar.

By any definition the Midwest has encountered serious economic difficulties for the past four years, commencing roughly with the Iranian oil embargo of 1979. Trouble had been building under the surface for a much longer period, but prior to 1979 our region was still generally prosperous. Previous business recessions since World War II had impacted the region seriously, but activity always rebounded to new highs in a year or so once a recovery was firmly underway. Since 1979 there have been no sustained recoveries.

Employment Trends

Trends in employment and unemployment constitute our best indication of the state of economic health of the Seventh District or any other region.

In March, the latest month for which consistent data are available for all states, nonfarm payroll employment in the five-state area was 3 percent below March 1982. Nationally, employment was down 2 percent. Manufacturing employment was down 8 percent from a year earlier in the District and down 6 percent nationally. (See table 1)

Despite some callbacks in the auto and building materials industries, there is no clear evidence that employment has risen significantly in the District since March. Moreover, information on help-wanted advertising and surveys of employer hiring intentions offer little hope for a significant upturn in the near future. Summer jobs for students will be hard to find. An unusually large share of spring graduates from high schools and colleges find the end of the school year approaching with no firm job offers in hand.

The trend of employment is particularly disturbing when viewed over a longer time span. In March, nonfarm payroll employment in the U.S. was 1 percent below March 1979. From 1947 through 1979 payroll employment increased nationally at a compounded rate of 2.3 percent annually. If this trend had continued, payroll employment, nationally, would be 9 percent higher currently than in early 1979. In the District, payroll employment in March was 10 percent below the level of March 1979, with declines ranging from 5 percent in Wisconsin to 14 percent in Michigan. Instead of being 10 percent lower than in 1979, employment in the District would be substantially higher now if growth had continued at the earlier rate.

Manufacturing employment in the U.S. in March 1983 was 14 percent below March 1979. In the District, the decline was 26 percent, with declines ranging from 21 percent in Wisconsin to 29 percent in Michigan. In

addition, many workers currently are on short work weeks. Aside from manufacturing, employment is at sharply reduced levels in construction and some types of transportation.

Unemployment Trends

Payroll employment data are based on reports of employers to government agencies. Unemployment is much more difficult to measure accurately. Data on the number of people receiving unemployment compensation comprise a major input for state and local unemployment estimates which are derived through a complicated process. Unemployment compensation data do not include either people who lose jobs and are not covered by unemployment insurance, or new entrants and re-entrants to the labor force. Problems such as determining whether an individual is "actively seeking work," is a "discouraged worker," or is insisting on unrealistic terms of employment (and other measurement problems) impose obstacles to precise estimates of unemployment. Despite these provisos, we can assert unequivocally that unemployment is high--at the highest levels since the Great Depression of the 1930s--and that the problem is more severe in the District than nationally.

In March unemployment was estimated at 10.3 percent of the labor force nationally and 12.5 percent in the five-state area, with a range from 9.8 percent in Iowa to 15.7 percent in Michigan. A year earlier the rate was 9.0 percent nationally and 11.5 percent in the District. (See table 2)

In early 1979, unemployment nationwide was high by standards of the 1950s or 1960s, but low by today's yardstick. In March 1979, the rate was 5.8 percent, nationally, and 5.8 percent in the District, with a range from 4.0 percent in Wisconsin to 7.1 percent in Michigan. In short, four years ago unemployment was about equally serious in the District and nationally. Since then the problem has been more serious here, and substantially so.

Local Unemployment

Unemployment problems vary by locality. In the past year or two jobless rates have been estimated at 15 to over 20 percent for industrial centers such as Rockford, Illinois; Gary, Indiana; Dubuque, Iowa; Flint, Michigan; and Racine, Wisconsin. Unemployment is chronically high among minorities in the large cities, especially Chicago and Detroit. (See tables 3 and 3A)

Depressed conditions in smaller centers often reflect declines in jobs, temporary or permanent, at the principal establishment in "one industry towns." Also, local labor markets often are not clearly defined. Many workers are willing to drive 50-60 miles or more to work and return each work day. A different situation exists in the inner cities where unemployed workers may be unable to commute to suburbs--where jobs often are more available--because of limitations of public transportation.

Dimensions of Unemployment

The distribution of unemployment by age, sex, and race is similar in District states to the national pattern. (See table 4)

Unemployment has increased substantially in the recession for all groups. Unemployment, as always, is particularly high for teenagers compared to adults, and for blacks relative to whites. One pattern of unemployment, however, has shifted in the past two years, both nationally and regionally. Historically, jobless rates were lower for men than for women. Currently, jobless rates are higher for men. Partly, this may reflect legal pressure to hire and retain women employees. A more important reason, however, is that unemployment has been heaviest and most prolonged in durable goods manufacturing and in construction, sectors where female workers are relatively few.

Concerning unemployment by industry, the current recession has repeated the course of earlier declines, with the heaviest layoffs in the most cyclical industries--hard goods and construction. The main difference this time is the

long duration of the problem, coupled with increasing concern that cyclically depressed industries will never fully recover, at least not in the form in which they existed prior to 1979. Many factories have been closed and demolished. In others equipment has been removed and disposed of at auction.

Population Growth

Population in the five-state area has been growing less rapidly than in the nation for a century. In 1930, the area had 17.1 percent of the nation's population. By 1970, this ratio had dropped to 16 percent. In the 1970s the drop in the ratio accelerated. By 1980 the five states had only 14.9 percent of the nation's population, and by 1982 14.6 percent. (See table 5)

From 1960 to 1970 the U.S. population rose 13.4 percent while population in the five states rose 10.8 percent. In 1970-80, growth was 11.4 percent for the U.S., and 4.2 percent for the five states. From 1980 to 1982 U.S. population rose 2.2 percent (according to Census estimates), while the five-state area declined by 0.3 percent. Indiana, Iowa, and Michigan lost population in 1980-82. The reduction or reversal of population growth reflects, in large part, migration of job seekers to the South and West.

Population loss is associated with reduced job opportunities. Fewer people means less need for all consumer goods and services, including housing. Fewer workers are required to supply these needs when population grows at a slower pace or declines.

The Industry Mix

In large degree the relative increase in unemployment in the Seventh Federal Reserve District reflects the composition of industry and the distribution of employment in the region.

In 1978, when business activity in the Seventh District was still robust, 15.7 percent of the nation's nonfarm payroll employment was in the five-state

area, somewhat more than the proportion of the nation's total population residing there. These states accounted for 19.3 percent of the nation's employment in manufacturing, and 23.4 percent of employment in durable goods manufacturing. Within durable goods, these states accounted for 31 percent of employment in steel, 55 percent in engines and turbines, 56 percent in farm machinery, 35 percent in construction machinery, 35 percent in metalworking machinery, and 54 percent in motor vehicles. (See table 6)

The five states accounted for a very high proportion of the nation's employment--ranging up to 70-80 percent--in farm tractors, heavy earthmoving equipment, industrial cranes, diesel engines, recreational vehicles, and outboard engines.

Reasons for the Decline in Durable Goods Employment

In the past four years, all of the durable goods industries reduced employment sharply. Moreover, in many cases the District's share of the nation's employment in those industries has declined. Among the causes are the following:

1. Generally depressed conditions in the nation which always affect durables most severely because these are relatively expensive, postponable purchases.
2. High interest rates that increase the cost of financing investments in long-lived equipment, customarily purchased on credit both by consumers and business.
3. High fuel costs which have deterred outlays on types of motor vehicles--larger cars and trucks and recreational equipment--output of which is concentrated in the Midwest.
4. A relatively small District proportion of production of energy development equipment, which, until late 1981, was a booming industry.

5. Relatively small District involvement in production of defense equipment, which has been expanding rapidly in recent years.
6. Low farm income, which has caused farmers to curtail purchases of equipment.
7. Migration of industry to the "Sunbelt," encouraged by lower employment costs, lower fuel costs, and financial incentives offered by southern states.
8. Concentration of production by some producers in more modern southern plants that had supplemented northern operations in earlier years when demand was strong.
9. Increased competition from abroad with the high value of the dollar and foreign subsidization of industry, including favorable credit terms, tending to reduce U.S. exports and encourage imports. (Components, as well as complete machines, increasingly are imported.)
10. Much lower labor costs abroad, sometimes only a small fraction of domestic costs. (Frequently foreign plants that utilize American technology are owned in whole or in part by American companies.)
11. A slippage in American technological leads, partly because of the export of U.S. technology through licensing or other means.
12. In the past year, reduced exports of U.S. capital goods to oil exporting nations whose oil revenues were cut by smaller shipments and soft prices.

Energy Costs

The huge rise in the price of energy since 1973 has had a direct, adverse effect on demand for vehicles and other District products that use fuel. There is another dimension to the problem. Per capita energy use in the

District is relatively high. This includes fuel for heating homes and other buildings, for transportation, and for industrial processes.

District states produce only a very small proportion of the energy they consume--oil, natural gas, and coal. Illinois has vast underground supplies of high sulfur coal, but usage has been closely restricted by anti-pollution regulations. As a result, coal burned by Midwest electric utilities is now largely imported from the Rocky Mountain states. Oil and natural gas come mainly from the South, the Southwest, and abroad.

The price of fuel at the source or at ocean ports becomes even higher when transportation costs to the Midwest are added. In addition, energy-producing states levy heavy severance taxes on coal, oil, and gas production. As a result, fuel users in District states help pay costs of government in fuel-producing states. In 1981, severance taxes as a share of total tax revenues in the principal oil and coal producing states ranged from 21 to 50 percent.

High Labor Costs

Wage rates in the District have been above the average for the nation for many years. The "gap" is widest in Michigan, where hourly earnings of production workers in manufacturing in 1982 averaged nearly one-third higher than for the U.S. Wage rates in other Seventh District states were 10 percent to 18 percent higher than the national average. (See table 7)

In addition to wages, total worker compensation includes benefits such as vacation pay, pensions, medical and dental insurance, workers' compensation, supplementary unemployment benefits, and many others. These benefit packages tend to be very liberal in durable goods industries as a result of successive "improvements" obtained in union contracts over the years. In heavily unionized areas such as the Michigan automotive centers, worker compensation

in non-unionized industries such as banking tends to be influenced by the terms won by unions. Unionization in the District has become increasingly important in state and local government, education, and food retailing.

Total compensation of production workers in the steel, auto, and construction and farm equipment industries averages at least $20 per hour, well over $40,000 on an annual basis. This compares with total costs estimated at $12 per hour in Japan, and much lower levels in other parts of the Orient and in Mexico. These areas are involved increasingly in "off-shore" sourcing of components.

In the past year, unions have yielded some "concessions" on wages and benefits. But, overall, there is still a wide gap in compensation differentials in District industries compared with other regions and foreign nations.

Productivity

High levels of hourly compensation can be countered by gains in labor productivity, output per hour. Productivity had been rising at a rapid pace of 2 to 3 percent annually through most of the postwar period. Since 1977, however, there has been no growth. Increases in productivity are expected to resume in 1983 if economic activity increases as expected.

Productivity growth in District industries has been hampered by a number of factors. Some relate to labor problems such as absenteeism, strikes, and restrictive work rules on job assignments, overtime pay, and discipline. The District also has a disproportionate share of the nation's older industrial facilities which compete with newer plants (often located in other regions or countries) planned and constructed at a higher "state of the art." Managerial shortcomings, now undergoing correction, also have limited improvements in productivity.

Federal Spending

The five District states contribute a much higher proportion of the federal government's revenues than they receive in federal disbursements. This is especially true in the case of national defense. This disparity tends to reinforce other factors adversely affecting economic activity in the region.

The five District states have 15 percent of the nation's population and generate about 15 percent of its personal income. Their contribution to federal revenues is probably slightly in excess of 15 percent. These states receive a much smaller share of federal outlays disbursed in the United States, only 10.7 percent of the total and only 5.1 percent of the outlays for defense. (These data exclude interest paid and certain other items not allocable by state.) (See table 8)

The relatively low participation of the District in federal outlays stands out dramatically in comparisons with other states on a per capita basis. The five states have five of the six bottom slots among the 50 states in per capita total federal spending and four of the lowest seven positions in defense spending. Indiana ranks highest in the District in defense, but is still only 34th. States with the highest per capita federal outlays are those with relatively high proportions of federal payrolls, civilian and military, and defense procurement.

State and Local Governments

Until the late 1970s, state and local government employment in the District had tended to offset periodic declines in private employment, rising even in recession years. In the past two years, state and local governments throughout the District have been grappling with serious financial problems.

Revenue shortfalls have reflected both the recession's effect on tax revenues and cutbacks of federal aid. Meanwhile, requirements for social programs and welfare outlays have increased.

State and local governments are dealing with their financial problems by (1) curtailing programs (often reducing employment), and (2) raising taxes. While these steps are necessary to achieve financial solvency, they work to reinforce the recession.

The Farm Economy

In some periods in the past when durable goods manufacturing was curtailed, the farm economy of the District was relatively prosperous. In the past three years, declining farm income has coincided with and reinforced the contraction in manufacturing. Many smaller communities are dependent on sales of equipment, supplies, and services to farmers.

Data on agriculturally-related employment are sparse, rendering precise characterizations of the situation difficult. Yet, there is no doubt that rural communities and the industries serving agriculture have suffered extensively in the economic downturn of recent years. There are signs that the farm sector is beginning to recover. But any recovery in agriculturally-related employment in the Midwest and nationwide, is likely to be slow.

1983 Acreage Set-Aside

The level of farmer enrollment in government farm programs suggests some 82 million acres will be removed from crop production in 1983. Even allowing for slippage in final compliance, it is probable that the acreage removed from production this year will be nearly a fifth of the area planted to principal crops in 1982--the largest removal ever under government programs. The decline in acreage will be sufficient to return the farm sector to a much stronger financial footing.

In the interim, industries that furnish inputs and services to farms will experience weak sales. Sales of seeds, fuels, fertilizer, and pesticides probably will decline at least 10 to 15 percent this year. Purchases of grain storage facilities also will decline. Unit sales of farm equipment, down 50 percent from the levels of the late 1970s, will remain at very depressed levels, but may begin to strengthen late this year as farm earnings improve. Transportation needs will be reduced. The demand for new farm loans will weaken, but creditors will still be restructuring older problem credits.

The acreage cutback will affect employment in some industries more than others. In fertilizer and farm equipment, where product inventories are high and sales are primarily to agriculture, job losses will be substantial. Industries that rely on nonagricultural markets more than agricultural markets, such as transportation and pesticides, will be much less affected.

Big City Problems

A large share of unemployment in the District is concentrated in the distressed inner-city areas of the larger centers. Job opportunities of residents are restricted by inadequate education and other problems associated with disadvantaged groups. EEO and affirmative action programs may fail to improve access to jobs in affected areas because some employers will move their operations elsewhere.

Despite high unemployment, there is a continuing need for workers in low-paying, less desirable jobs. Availability of such jobs has brought a steady influx of aliens to the District--mainly from Latin America, the Orient, and Eastern Europe. Many of these aliens are in the "underground" economy, not counted in the labor force.

High crime rates deter businesses from locating in the inner city, and in some cases may be the deciding factor in decisions to migrate. Fear of violence may make valued employees unwilling to travel to inadequately policed

neighborhoods. Insurance costs are high because of possible damage to property, especially through arson. Theft of supplies, materials, and finished goods also raises operating costs.

Employment growth in the central business districts of large cities has been dampened by a number of factors, including decentralization of corporate headquarters and automation of financial and other services. Many banks, insurance companies, public utilities, and government bodies have reduced staff in the past year or two. Until the mid-1970s, most of these employers were hiring actively year after year. Currently, they offer few new job opportunities with openings often filled by transfers of "redundant" workers from other departments.

Pollution Controls

Regulations controlling industrial emissions--air, water, and solid wastes--have had a disproportionate impact on the Midwest. Emission controls can be incorporated at lower cost in newly constructed facilities. Deadlines for meeting emission standards imposed on older plants may be satisfied easily by closing the plants. Often closings have been the answer, especially for foundries. Such decisions have been encouraged by the income tax code. Many Midwest plants, once locally owned, have been acquired by conglomerates whose owners may benefit from tax write-offs when older facilities are shut down. This has been the major incentive for some acquisitions.

On January 31, 1983, the EPA proposed a ban on construction of major industrial facilities in 144 United States counties--including those in the areas of Chicago, Detroit, and Milwaukee--for failure to meet deadlines and requirements for improving air quality. The EPA maintains that the ban is mandated by existing law, even though it would slow the cleanup by extending the use of old facilities with high levels of harmful emissions.

Business Environment

Business groups complain of "unfavorable business climates" in the industrial states of the Midwest. Costs of unemployment insurance and workers' compensation are relatively high in this region, especially in Illinois and Michigan. (See table 9) These costs reflect both the size of payments and the ease of establishing claims. Other complaints involve high taxes, state pollution controls, restrictions on cutoffs of utility services, and laws affecting hiring and personnel practices.

Earlier this year Alexander Grant and Co. published its fourth study of General Manufacturing Business Climates in the 48 contiguous states. States were assigned overall rankings for 1982. Florida, Texas, and North Carolina took the top three spots. Indiana was 29, Iowa 35, Wisconsin 36, Illinois 42, and Michigan 48. Among the adverse factors considered:

Relative cost of fuel and electricity. Costs in the Great Lakes states were 41 percent greater than in the South Central Region, and 4 percent more than the national average.

Wage costs. Michigan had the highest wage costs of any state. The average for the Great Lakes states was 40 percent higher than for the Southeastern states, and 18 percent above the national average.

Unionization. In the Great Lakes states 31 percent of nonfarm workers were organized, compared to less than 10 percent in the Carolinas.

Taxes. Taxation in the Great Lakes states, relative to incomes, was about equal to the national average, but higher than in the Southeastern states.

Financial Condition of Business

Some large District companies that were in excellent financial condition a decade ago are now operating under severe stress. Their problems usually are a result of several factors--sales falling below expectations, intense

competition, rising costs of labor and other inputs, and heavy debts incurred at high interest rates. Some of these firms are operating under special agreement with creditors who could force them into bankruptcy under contractual agreements.

Erosion of executive morale and confidence which has developed over the past several years will not be corrected in a year or two. Until financial strength is solidly reestablished and the general economy is clearly in a new growth trend, business caution will restrain commitments for capital spending, inventory investment, and hirings.

The Outlook

Projections of employment and unemployment are subject to substantial error. Forecasts by District state governments and regional development organizations in recent years have proved much too optimistic.

The main factor affecting conditions in the Midwest in the future will be the trend of the national economy. A strong and sustained recovery would eventually bring sharply higher orders for the District's capital goods. However, most of the adverse factors described above can be corrected only gradually. Many manufacturing operations closed in recent years will never reopen. Steel will be a lesser factor in economic activity than in the past. Some of the service industries--for example, financial futures trading--are growing steadily, but this will not replace a vigorous manufacturing sector.

A number of other factors could influence District developments:

1. Successful labor-management agreements to reduce costs.
2. A less oppressive regulatory climate, including administration of pollution controls.
3. Restriction of the sale of tax write-offs and losses that encourage plant closings.

4. Restrictions on severance taxes imposed by fuel producing states.
5. Direction of a larger share of federal disbursements to District states.

In the long run, the Midwest should regain its economic health, although not in the same form as in earlier decades. Adjustments in business, agriculture, labor, and government are already underway. The basic resources that brought prosperity to the region are still present--excellent transportation, ready access to raw materials and markets, ample fresh water, a well-educated work force, and a highly productive agricultural hinterland.

Role of the Federal Reserve

. A major precondition for sustainable economic growth and reduced unemployment in the nation, and especially in the Midwest, is the maintenance of a non-inflationary environment. The Federal Reserve has a vital role in the effort to achieve and maintain price stability. A resurgence of inflation would recreate the distortions in business and individual decision-making that have led to ever higher rates of unemployment in the successive business cycles of the post-World War II period and would seriously limit chances for economic expansion and improvement in job opportunities.

I emphasize the importance of price stability because of the havoc caused by inflation on the Midwest economy. In large degree the economic problems of the Midwest have been caused, or at least exacerbated, by inflation.

For many years, inflation nurtured an illusion of economic well-being while cutting deeply into the region's economic strength. Inflation is accompanied by increases in operating costs, costs of carrying inventory, and capital investment. If rising costs are not fully reflected in increased selling prices, real profits decline. Lenders fearful of the erosion of their investment through inflation insist on shorter maturities. Long-term funds

become less available and borrowers with long-term horizons are less able to undertake investments. Cut-off rates of return are raised and corporations look for investments with shorter pay backs. Purchases of existing assets may appear preferable to financing new plant and equipment.

With a large proportion of its manufacturing employment in durable goods, our District has been hard hit by the sluggishness of new investment. A non-inflationary environment will revitalize long-term financial markets, increase the incentives for investment, and greatly improve the employment outlook. This does not mean that our industries will fully recover their former positions of strength. The basic structure of the market for capital goods has changed.

The process of recovery appears to have started in manufacturing, but it could be sidetracked by another surge of inflation. The process of adjustment is painful and the costs are high. But an attempt at short-term improvement by acceding to inflationary economic policies would cause even greater long-term losses to the Midwest.

Price stability fostered by appropriate national monetary policy under the guidance of the Federal Reserve System is a necessary condition for the reduction of both inflation and unemployment. There is also a role for the individual Reserve Banks. The complex process of economic adjustment involves social as well as economic objectives that may be in conflict. Moreover, the objectives of various regions may clash. Cooperative national and regional efforts are required. In this intricate environment the Reserve Banks cannot determine the changes to be made, but they can assist, serving as a focal point for studies of the region and as a catalyst for cooperative efforts.

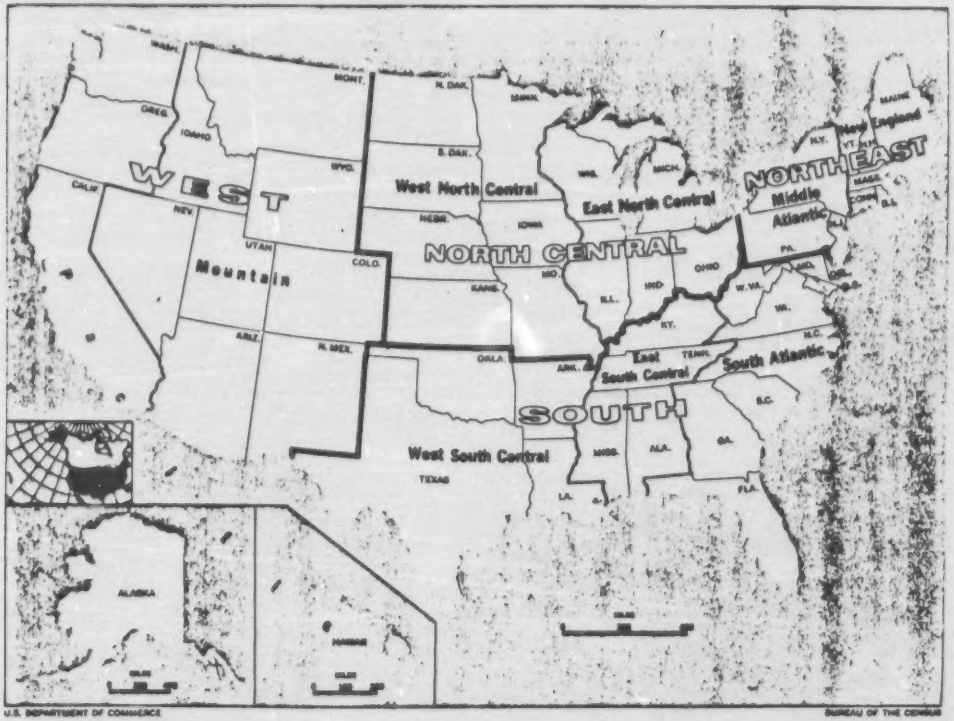
To this end, the Federal Reserve Bank of Chicago is expanding its economic information facility. For many years we have provided information on current and prospective developments in our region. We are now supplementing this function to provide regional economic data quickly to interested analysts. We are also increasing our own research efforts in the analysis of resources of the region and the areas of opportunity for economic growth. Impediments to growth and development such as usury ceilings, excessive regulation, and unnecessarily costly aspects of workers' compensation and unemployment compensation are being identified and the opportunities for modifying these restraints are being evaluated.

We are aware of severe financial strains on Midwest state and local governments faced with the heavy costs of caring for the poor and restoring a deteriorating infra-structure, despite serious revenue short-falls. Recent tax increases may adversely affect local economic activity. We are undertaking a special effort to understand the financial problems of state and local governments. In this connection, we plan to host a conference this fall to explore possible solutions.

Finally, we are increasing our involvement with regional groups interested in evaluating and implementing programs to assist local adjustments. Effective programs to advance the welfare of the region require the cooperative efforts of all segments of the community. We hope that our participation in producing information, analysis, and ideas will further this vitally important objective.

I appreciate your invitation to testify and your interest in the problems of our region.

CENSUS REGIONS AND GEOGRAPHIC DIVISIONS OF THE UNITED STATES



U.S. DEPARTMENT OF COMMERCE — BUREAU OF THE CENSUS

Table 1
Employment
Nonagricultural Payrolls
(not seasonally adjusted)

	Mar. 1980 to Mar. 1981	Mar. 1981 to Mar. 1982	Mar. 1982 to Mar. 1983	Mar. 1980 to Mar. 1983	Mar. 1979- to Mar. 1983
	(percent change)				
Total					
United States	0	- 1	- 2	- 2	- 1
Five States	- 3	- 3	- 3	- 9	-10
Illinois	- 4	- 2	- 3	- 9	- 7
Indiana	- 2	- 4	- 3	- 8	-12
Iowa	- 3	- 5	- 2	-10	-10
Michigan	- 3	- 5	- 2	-10	-14
Wisconsin	- 3	- 1	- 3	- 7	- 5
Manufacturing					
United States	- 3	- 4	- 6	-12	-14
Five States	- 7	- 8	- 8	-21	-26
Illinois	- 9	- 7	-11	-24	-26
Indiana	- 4	- 8	- 9	-19	-27
Iowa	- 8	-11	- 7	-24	-25
Michigan	- 6	- 9	- 6	-20	-29
Wisconsin	- 8	- 4	- 9	-19	-21

Table 2
Civilian Unemployment Rates
(seasonally adjusted)

	March					Apr.
	1979	1980	1981	1982	1983	1983
	(percent)					
United States	5.8	6.3	7.3	9.0	10.3	10.2
Five states average	5.8	7.6	9.5	11.5	12.5	
Illinois	5.7	6.9	9.0	9.9	12.2	12.2
Indiana	5.8	8.4	10.0	12.1	11.8	
Iowa*	5.0	5.2	7.5	9.7	9.8	
Michigan	7.1	10.1	12.0	15.8	15.7	14.9
Wisconsin	4.0	5.6	7.8	9.4	11.0	

*Not seasonally adjusted.

Table 3
Civilian Unemployment Rates in Seventh
District States and Metropolitan Areas
(not seasonally adjusted)

	February 1982	February 1983
	(percent of labor force)	
Illinois	10.1	13.8
Bloomington-Normal	7.3	10.0
Champaign-Urbana-Rantoul	5.0	7.3
Chicago	9.4	12.4
Davenport-Rock Island-Moline	10.4	18.2
Decatur	12.3	19.3
Kankakee	15.8	21.4
Peoria	10.7	19.2
Rockford	14.5	18.1
Springfield	7.6	10.6
Indiana	12.7	13.2
Anderson	21.2	16.5
Elkhart	11.7	9.1
Evansville	11.3	11.9
Fort Wayne	12.6	13.3
Gary-Hammond-East Chicago	13.9	17.3
Indianapolis	9.8	10.6
Lafayette-West Lafayette	7.3	8.7
Muncie	16.9	14.7
South Bend	11.0	10.7
Terre Haute	13.1	14.9
Iowa	9.2	10.8
Cedar Rapids	9.6	11.1
Des Moines	8.3	8.8
Dubuque	12.9	16.9
Sioux City	8.4	9.2
Waterloo-Cedar Falls	10.9	14.2
Michigan	16.1	16.5
Ann Arbor	9.7	10.4
Battle Creek	15.6	17.1
Bay City	18.6	19.0
Benton Harbor	16.8	18.5
Detroit	16.5	16.7
Flint	22.8	19.5
Grand Rapids	12.7	13.2
Jackson	14.8	17.7
Kalamazoo-Portage	11.1	12.0
Lansing-East Lansing	13.2	11.7
Muskegon-Norton Shores-Muskegon Heights	16.0	19.6
Saginaw	20.2	17.2
Wisconsin	10.7	12.7
Appleton-Oshkosh	10.9	12.4
Eau Claire	10.5	11.6
Green Bay	9.7	11.3
Janesville-Beloit	19.1	13.5
Kenosha	12.1	12.4
La Crosse	9.5	10.1
Madison	7.3	7.7
Milwaukee	8.9	12.4
Racine	12.2	19.0
United States	9.6	11.3

Table 3A
High Unemployment Areas

The Emergency Jobs Act, signed into law on March 24, requires that a list of towns, cities, and counties with high unemployment be published by the Department of Labor. Federal agencies will use the list in conducting public works and service programs. To qualify, areas must have had average unemployment rates in 1982 of at least 8.8 percent, 90 percent of the average rate for all states.

	Number of high unemployment areas on April 23, 1983	Percent of United States
United States	2,163	100
Five States	404	19
Illinois	105	5
Indiana	91	4
Iowa	35	2
Michigan	104	5
Wisconsin	69	3

Table 4
Unemployment Rates by
Age, Sex and Race

	Total	Teenagers	Men	Women	White	Black and other races
	(unemployment as a percent of labor force)					
United States						
1978	6.1	16.3	5.2	7.2	5.2	11.9
1982	9.7	23.2	9.9	9.4	8.6	17.3
Illinois						
1978	6.1	15.0	5.3	7.1	4.8	14.8
1982	11.3	23.3	11.8	10.6	9.2	24.1
Indiana						
1978	5.7	17.3	4.4	7.4	4.9	14.8
1982	11.9	24.8	12.5	11.3	11.0	23.0
Iowa						
1978	4.0	9.8	3.8	4.2	3.8	*
1982	8.5	17.4	10.0	6.6	8.2	*
Michigan						
1978	6.9	17.4	5.7	8.6	5.9	14.4
1982	15.5	28.7	15.7	15.1	13.3	31.9
Wisconsin						
1978	5.1	12.8	4.3	6.3	4.8	16.4
1982	10.7	21.6	11.7	9.3	10.1	25.6

*Statistics not sufficiently reliable for publication.

Table 5
Population

	United States	Five States	Illinois	Indiana	Iowa	Michigan	Wisconsin
	(percent of United States)						
1960	100.0	16.3	5.6	2.6	1.5	4.4	2.2
1970	100.0	16.0	5.5	2.6	1.4	4.4	2.2
1980	100.0	14.9	5.0	2.4	1.3	4.1	2.1
1982	100.0	14.6	4.9	2.4	1.3	3.9	2.1
	(percent change)						
1960 to 1970	+13.4	+10.8	+10.2	+11.4	+ 2.5	+13.5	+11.8
1970 to 1980	+11.4	+ 4.2	+ 2.8	+ 5.7	+ 3.1	+ 4.3	+ 6.5
1980 to 1982	+ 2.2	- 0.3	+ 0.2	- 0.4	- 0.3	- 1.7	+ 1.3
	(millions)						
1982	231.5	33.7	11.4	5.5	2.9	9.1	4.8

Table 6
Nonagricultural Payroll
Employment
(annual average, 1978)

	United States	Five States	Illinois	Indiana	Iowa	Michigan	Wisconsin
	(percent of United States)						
Total	100.0	15.7	5.5	2.6	1.3	4.1	2.2
Manufacturing	100.0	19.3	6.1	3.6	1.2	5.6	2.8
Durable goods	100.0	23.4	6.8	4.7	1.3	7.6	3.0
Primary iron and steel	100.0	31.1	8.7	10.7	0.4	8.7	2.5
Engines and turbines	100.0	54.9	15.8	9.0	0.8	9.8	19.5
Farm machinery	100.0	55.6	21.0	3.1	16.0	4.3	11.1
Construction and related machinery	100.0	34.5	17.6	1.6	5.7	4.1	5.4
Metalworking machinery	100.0	35.0	10.2	3.5	0.3	17.8	3.2
Motor vehicles and equipment	100.0	53.7	2.8	6.9	0.9	39.8	3.4

Table 7
Average Hourly Earnings
of Production Workers in Manufacturing

	United States	Illinois	Indiana	Iowa	Michigan	Wisconsin
	(relative to United States)					
1965	100	108	112	107	123	105
1970	100	109	111	110	124	108
1975	100	114	114	112	127	109
1980	100	110	117	119	131	110
1982	100	110	115	118	132	110
	(dollars per hour)					
1982	8.50	9.31	9.79	10.00	11.18	9.37

Table 8
Federal Outlays, Fiscal Year 1982

	Total (billions)	Defense (billions)	Total (percent)	Defense (percent)
United States	$603.6	$178.8	100.0	100.0
Illinois	22.4	2.8	3.7	1.5
Indiana	10.1	2.6	1.7	1.4
Iowa	5.2	.5	.9	.3
Michigan	18.0	2.2	3.0	1.2
Wisconsin	8.9	1.1	1.5	0.6
Five States	64.5	9.1	10.7	5.1

Per Capita Federal Outlays

	Relative to U.S Average (percent)		State Rank	
	Total	Defense	Total	Defense
United States	100	100		
Illinois	75	31	46	44
Indiana	71	62	49	34
Iowa	69	22	50	49
Michigan	76	31	45	45
Wisconsin	72	30	48	47
Five States	73	35		

Source: Federal Expenditures by state for Fiscal Year 1982, Bureau of Census.

Table 9
State Unemployment Insurance
Average Weekly Benefits--Current $ 1981

	Amount	% of U.S.
United States	$107	100
Illinois	133	124
Indiana	91	85
Iowa	122	114
Michigan	128	120
Wisconsin	123	115

Source: Statistical Abstract 1982-83 p. 338

Maximum Weekly Payment for
Temporary Total Disability Under
Workers' Compensation Insurance 1982

	Amount	% of U.S.
Forty-eight states	$238	100
Illinois	403	169
Indiana	140	59
Iowa	501	211
Michigan	307	129
Wisconsin	269	113

Source: U.S. Chamber of Commerce, quoted in General Manufacturing Business Climates 1982 p. 47. Alexander Grant & Co.

Chairman FAUNTROY. I thank you both, Mr. Martin, and Mr. Keehn, for a very thorough and perceptive analysis of the employment and economic growth situation in the country generally, and in the seventh district in particular.

Mr. Keehn, your testimony here tends to depress me. As I listened to your litany of the causes of the downturn in that Midwest region, I would like to start off with a question for you as to where we ought to be going in terms of industrial policy in the country. What hope ultimately is there for this region?

Mr. KEEHN. As I tried to outline, I think the fundamentals are in place within the region for a longer term economic recovery. I have tried to highlight some of what we call the impediments to full growth in the region. And I think with the passage of time and a better understanding of these impediments, and hopefully a correction of the impediments, the area can return to a good level of economic activity.

The key to all of this, though, which I cannot emphasize enough, is the importance of price stability. Certainly a great many of our problems were caused by the high levels of inflation that we experienced in the seventies. With improvement on that front, and now some focus on the impediments which I have tried to outline, I think that as these are corrected, the region should ultimately return to good economic growth.

Chairman FAUNTROY. Mr. Martin, a number of private forecasters are predicting that unemployment will remain above 9 percent through 1984, and at 8-percent level in 1985. Is the forecast for unemployment used by the Federal Open Market Committee consistent with these predictions, more optimistic, or more pessimistic?

Mr. MARTIN. Mr. Chairman, I am aware of the projections that you have indicated. The projections of the Federal Open Market Committee have been submitted for a shorter period of time. We have submitted them for this year and on a fourth-quarter basis. But to answer your question more fully, I believe that our projections are slightly more pessimistic than those that you have cited. However, our projections for the price indexes are somewhat more optimistic than most forecasters.

Back on the question you addressed to President Keehn, if I could, sir, I would only add to his statement that we have had some experience in the New England States over time, in what is to us the first district in the Federal Reserve System, in which the private community, local, and State government, and indeed our Federal Reserve people in that district have, over time, worked together to attract new payrolls, the so-called high technology kind of companies, particularly around the Boston area.

I think that the first step in progress on a regional basis in the kind of recognition that Mr. Keehn was indicating here—that the good old days are behind us, that the future is going to be different, and that new approachs have to be sought after to remedy these matters.

Chairman FAUNTROY. In that regard, I wonder if you would care to comment on President Keehn's reference to the fact that the relative investment of Federal Government resources in the Midwest is low, and whether an increased investment in the Northeast contributed to the recovery that that sector has experienced.

Mr. MARTIN. Mr. Chairman, I am sure it was contributory. But I also seem to remember that, over the same period of time, let us say the last 10 or 12 years, in New England, while there was certainly consideration specifically by the Congress in the appropriations process, there were also some substantial military installations that were moved out of New England at the same time. So I think it was a mixture of crosscurrents in that regard.

Chairman FAUNTROY. You both stressed the cost of inflation—the cost it has inflicted on the economy in the past and the risks that it poses for the future. I understand and agree that we should be attentive to prevent a resurgence of inflation, but are there not risks that the Fed could become so fearful of inflation that it would stifle this recovery? For example, M-1 velocity was unusually low during 1982, and remained negative during the first quarter of this year. Yet current M-1 growth rates are being viewed as inflationary by many observers. If the Federal Open Market Committee responded to these fears of future inflation by tightening monetary policy, even though M-1 velocity is still declining, wouldn't that raise interest rates and slow the recovery?

Mr. MARTIN. Certainly, if we were to diminish the rate at which we are providing bank reserves through the open market operations, there would tend to be a pressure on short-term rates. The complication of markets today is the instantaneous nature of information exchange, and, therefore, what happens to expectations. There are times when the growth of one or another of the monetary aggregates tends to provoke expectations of future inflation, and those expectations themselves run up interest rates.

So we have to be very careful not to give signals to the market that we are either being too easy, which markets may translate into future inflation, or too restrictive, which places additional pressures on market rates. We need to avoid either extreme.

Chairman FAUNTROY. Mr. Keehn, would you care to comment on the question, as well?

Mr. KEEHN. I would only add to Mr. Martin's comment that in various testimony and releases that the Federal Reserve System has put out, clearly, we have noted that we are in a period in which M-1 is going through some significant shifts. As we go through this period we are placing a lesser emphasis on M-1 and higher level of emphasis on M-2 and M-3.

Therefore, I think more broadly that overall policy is one being conducted very effectively.

Chairman FAUNTROY. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

I would like to address a question to both gentlemen. Unemployment nationally is at 10.2 percent with, as the chairman mentioned earlier, additional underemployment by a large number of people, and a large number of people who have actually left the labor force.

I think, Mr. Martin, you mentioned there were several factors, several components to the unemployment rate—structural, cyclical, and frictional unemployment. I wonder if you might tell me what share of the 10.2 percent is each of those three factors—structural, cyclical, and frictional?

Mr. MARTIN. I would be glad to submit to you and to the subcommittee our thinking on this. I would only caution that there has been over time, despite the heroic efforts of labor economists and others, no very satisfactory delineation among those factors. It is particularly difficult to tell what is structural unemployment—how many steelworkers in Mr. Keehn's Federal Reserve district are trainable and reluctant to move to a different industry, and perhaps at a lower wage rate. I will respond to the best of our ability, but with the caution that we don't have a nice theory and a nice econometric model which is very helpful in this regard.

[In response to the request of Congressman Hiler, Vice Chairman Martin submitted the following information for the record:]

Vice Chairman Martin subsequently submitted the following information for the record:

Elements of each source of unemployment--frictional, cyclical, and structural--cut across all groups of workers and many economic situations. Because the distinctions are so cloudy, I am not able to separate the current pool of unemployed into three distinct groups. I can, however, offer some of my thoughts on the sources of unemployment and my interpretation of the current unemployment situation.

Frictional unemployment, as I see it, can occur in a wide range of circumstances: as workers enter the labor market for the first time, as they reenter after a period outside the workforce, or as they change jobs. In tight labor markets or for those workers whose skills are in short supply, this source of joblessness should be of relatively short duration. However, during periods of slack demand or when changes are occuring rapidly in regional or national markets--as I believe has been happening in recent years--individuals whose joblessness at first appeared frictional may find themselves facing cyclical or structural problems.

Cyclical joblessness is most readily associated with temporary layoffs that occur during general economic recessions. These workers normally are not looking for other, permanent jobs during an economic downturn because they have reasonable expectations of returning to their former jobs relatively

quickly during an economic recovery. This type of unemployment will be best alleviated by macroeconomic policies designed to achieve a solid, noninflationary economic recovery.

Structural unemployment, as I pointed out in my prepared statement, can occur among those workers who lack the training to meet employers' needs as well as among highly skilled workers who become displaced from their jobs as patterns of labor demand shift. The transition of these workers to new locations or the acquisition of new skills can be expected to occur slowly, and structural joblessness is often associated with long duration unemployment. Because the persistence of long duration joblessness involves high social costs and may be economically inefficient, it is appropriate, I believe, to use our employment and training programs to ease the transition of the structurally unemployed into the mainstream of the workforce.

Looking at the current pool of the long duration joblessness, the separation of the structurally unemployed from the frictionally and cyclically unemployment is especially difficult. In May, for example, 2-3/4 million of the more than 11 million unemployed workers had been jobless for more than 26 weeks. A separate report showed that 2 million persons were receiving extended duration unemployment insurance benefits, which suggests that many of the workers currently out of work for more than 26 weeks have some recent job experience. How many of these workers can reasonably expect to return to their former jobs is not clear.

During past business cycles, the economic recovery brought a sharp reduction in long term unemployment. For example, during 1979, the last year of very tight labor market conditions, the count of long term unemployment stood at just 500,000. Thus, it might be argued that a quick return to the labor market conditions of 1979 could alleviate the bulk of long-duration unemployment. But, it is also probable that over the past three years, economic conditions have changed fundamentally, particularly in international markets, and structural shifts in labor demand have accelerated. Indeed, as Mr. Keehn has suggested, some of our core industries are not expected to rebound quickly to their former peak levels of activity. In this environment, I believe it is appropriate to review the set of employment and training policies now available and to attempt to ensure that they will improve the match of workers with the jobs to be generated by the non-inflationary economic recovery we are now projecting.

Mr. HILER. Mr. Keehn, do you have any response?

Mr. KEEHN. I would just add that it is a very, very difficult assessment; you are talking about a broad aggregate, that is very hard to divide. Having said that—and in my fuller testimony there are some supporting tables—we have been running in the Middle West at about a 2 percentage point higher rate of unemployment than is the case for the national average. I think that begins to give us some feeling that the level of structural unemployment in the district is comparatively high.

As we go further into the recovery, we would expect that 2-percent gap to narrow. But not all the way. It will probably end up having a 1- or 1½-percent differential between unemployment in our district and in the national average. That may give some feeling as to the structural level of unemployment in our district.

Mr. HILER. Once again, the question directed to both gentlemen: What would you consider full employment to be today?

Mr. MARTIN. There is certainly a lot of debate in the academic community with regard to this issue, taking into account the rise in labor force participation and the slowdown in growth of labor productivity that has damped the expansion of our economic potential. Most researchers, I believe, tend to come in with figures that are above those that 10 or 15 years ago we would have thought normal. So that I see more often quotations of 6 to 7 percent—some lower than that—as some sort of an unemployment rate consistent with noninflationary economic growth.

We are far above those rates today.

Mr. HILER. Mr. Keehn?

Mr. KEEHN. I think the employment market and the labor force are changing, so dramatically and so rapidly that it is hard to assess what would be a precise figure. Certainly, it is higher than 4 percent, which we have used in the past. I haven't seen anything that would give me any assurance that a level of 6 or 7 is absolutely full employment. But I would tend to think that it is in about that area.

Mr. HILER. Mr. Keehn, I think in your prepared testimony you commented that unemployment was at its highest level since the Depression. How about employment in terms of a percentage of the labor force, potential labor force, and also in aggregate numbers of people?

Mr. KEEHN. If you would take a look at table 1 in my prepared statement, we give some employment numbers for the district as they relate to the Nation over periods of time, going back to 1979. Clearly, we are operating at a disadvantage in terms of employment in the district.

Mr. HILER. I think you are answering a different question than I may be asking.

Mr. KEEHN. Sorry.

Mr. HILER. In your statement—and I can't remember what page it was on—but you said unemployment was at a post-Depression high. I presume you meant both in percentage terms and in total number of unemployed people in the country?

Mr. KEEHN. Yes.

Mr. HILER. You were referring to the over 10-percent unemployment.

Mr. KEEHN. Yes.

Mr. HILER. I was curious, if you take in terms of employment, aren't we also at a very near record for employment in terms of percentage of the potential labor force and in utilization——

Mr. KEEHN. Sorry, I missed your point. In terms of the absolutes, the employment level would be higher than it was in the Depression. In relatives, I was just suggesting that the employment rate is not as high as it has been.

Mr. HILER. If I might just ask one more question, Mr. Chairman, in this round.

Mr. Keehn, you mentioned in your statement, I think as the chairman had commented, just a whole litany of factors that have affected the region. I think some of the things you mentioned—absenteeism, State and local taxes, unemployment compensation, disability benefits, wage rates, percentage of old capital and older factories, number of strikes, percent unionism—just a whole variety of things—if we have an above-average recovery over the next 2 to 3 years, how much of the unemployment problem that we have in that Midwest region that you are from would go away, and how much is due to these other factors that really are almost beyond the ability of the Federal Government to directly influence?

Mr. KEEHN. I can't give you an exact amount. But I can certainly reply that I think the structural issues that I have tried to outline—the pollution control laws, for example, the higher than average employment costs in our district—make it very difficult for the region to recover on a fully competitive basis with the other areas.

So I think that even with a very good recovery, we will lag, to some extent. Having said that, capital goods are terribly important in our district. And they will lag. We will get to a point if the recovery continues, then the capital side will begin to show improvement. That will be fundamentally important to our district.

But, even then, these heavy capital industries are going to be operating at a disadvantage because of the reasons I have tried to cite in my testimony. And I think it will be important that people understand these issues and try and correct them so that as we go forward on the longer basis we can continue and be fully competitive.

Mr. HILER. Thank you.

I yield back, Mr. Chairman.

Chairman FAUNTROY. The gentleman from Georgia, Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Martin, if you could just for a second this afternoon take us into the inner sanctorium of the Federal Open Market Committee, could you tell us some of the considerations that go on there in determining the scope of the monetary policy? I mean, what are some of the indices that are considered in making those decisions?

The reason I am getting around to the whole question, is unemployment at any time considered?

Mr. MARTIN. Yes, Congressman Barnard. There are events that lead up to the actual determination of ranges for the broad monetary aggregates. And the verification of numbers for M1 and for Federal funds rate, and this new non-financial credit variable.

Preceding that stage, there are many hours of consideration, beginning usually with the reviews of the reports from the 12 Federal

Reserve Bank Presidents, including Mr. Keehn, as to the economic conditions in each Federal Reserve district, including the unemployment levels; the comments by the staff of the Federal Reserve Bank, perhaps by the Presidents themselves, with regard to particular industries, their condition, their employment, productivity, the outlook and other types of information.

On the national level, the staff briefs the members of the FOMC as to the many indexes of economic health. There are reviews, extensive reviews, of the economy, including the employment, unemployment, underemployment, and so forth. All of these matters are discussed prior to the review of international debt situations, credit situations, foreign economies; all of this prior to financial markets, interest rates, monetary and credit aggregates.

Mr. BARNARD. In setting the monetary policy for the entire country, then, there would be a feeling of unemployment writeoff in setting some of those targets at times; wouldn't it be so?

Mr. MARTIN. Well, certainly——

Mr. BARNARD. I mean, because unemployment varies, as we have stated today, in such a degree from one part of the country to another.

Mr. MARTIN. Yes, sir. The Congressman is quite correct—in setting national monetary policy, while it is necessary to review region by region, one finally comes to a putting together of the whole pattern, and setting national targets. That is correct.

Mr. BARNARD. Therefore, you would certainly disavow the criticism of the Federal Open Market Committee that no consideration is made of unemployment in setting monetary policy. You all do consider that?

Mr. MARTIN. Yes, sir. As a factual matter, we do.

Mr. BARNARD. You would feel probably not disinclined to want to comment, but the thing that concerns me is that the condition we have today, wasn't it pretty much predictable as far back as 10 years ago, with the high rates of inflation being what they were? Wasn't it very predictable that some place in time, we were going to get caught up in inflation to the degree that we were going to have this current situation?

Mr. MARTIN. I think there is some merit in what the Congressman says. In the early 1970's we were attempting to discharge our responsibilities around the world, and at the same time move into a very substantial expansion of our entitlement programs. We were beginning to be concerned about productivity.

Mr. BARNARD. That is when we have notably seen a decline in productivity.

Mr. MARTIN. Yes, sir.

Mr. BARNARD. The question is: Why didn't the Federal Monetary Committee take financial policy in hand at that time? Weren't we experiencing an overexpanding financial monetary market back in a period of time when we really should have been showing more restrictions?

Mr. MARTIN. Certainly one can look back and find periods of time in which we overexpanded the provision of reserves to the banking system. At any moment when FOMC is trying to look out into the future, we are acutely aware that forecasting is not only

not a science, but one can even question whether it is much of an art.

I cite the blue chip economic forecasts in which some 45 forecasts were shown there. The variation from what actually happened in 1982 was significant. We are aware that the best of forecasts have a wide variation around them. If you were on the side of underproviding monetary reserves in the early 1970's, then, of course, you may unduly tighten the credit by that measure and pay the price in unemployment and slower growth.

Mr. BARNARD. But this is what we have done in the last recent months, isn't that true? I mean, in other words, the present Federal Open Market Committee, the one dating back the last year and a half or 2 years, they have come to grips with the problem and they have said we are going to do something about it. It has had a writeoff in high unemployment and high interest rates.

So the point is, who made the best decisions? Were the best decisions made in the 1970's, or were they made in 1981 or 1982?

Mr. MARTIN. I find it very difficult to answer that question, but let me attempt it in a more or less technical way.

The selection of the data and the variables on which to target the provision of bank reserves and the application of monetary policy, vary depending on the circumstances. In one period of time, the external shocks which may come in and throw off the smooth application of monetary policy may come from the price sector. It may be there are unpleasant surprises in petroleum prices as in the two oil shocks we experienced over the last decade.

At another time, the surprise may come from the international credit side. And it may be a capital flow disturbance that comes in. Too much capital may come into the markets.

So one set of targets works better at one time and another set of targets works better at another time.

Mr. BARNARD. But surely you weren't surprised that present monetary goals were not going to affect employment. Surely that wasn't a surprise.

Mr. MARTIN. No, it was not, sir.

Mr. BARNARD. So I guess I am back around full scale now.

Do you think, then, that reducing inflation, which the Fed has been so successful in doing—and I compliment you—has had a normal and natural result in affecting unemployment?

Mr. MARTIN. I think it has affected unemployment to some degree. I think there are some other factors affecting unemployment that we have been reviewing. But, yes, sir, is the answer.

Mr. BARNARD. To go back to Mr. Keehn's observations—that we are in for a long spell of recovery, that our expectations should not be too high, from what I understand you to say, that we are going to be in a long-term adjustment in bringing unemployment down—were you speaking nationally, Mr. Keehn, or just from your area, your district?

Mr. KEEHN. Certainly, I was most particularly referring to our area because of the conditions which I tried to outline. I think we are going to go through a very difficult period of structural adjustment.

Mr. BARNARD. Thank you very much.

Chairman FAUNTROY. The gentleman from Tennessee, Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

I appreciated the list of factors that the Federal Open Market Committee considers in its deliberations. One factor, it seems to me, that should be considered is this factor: The financial markets seem to have been a little bit jittery in recent weeks. They seem to be increasingly jittery as the August deadline approaches for the appointment of either the same or a new Federal Reserve Chairman.

I was wondering if you all considered in your deliberations the state of the financial markets in terms of their reaction to the leader that you could have at the head of the Federal Reserve beginning in August?

Mr. MARTIN. It is certainly the immediate condition of financial markets as are reported to us by the people who deal in those markets, immediately before discussion of the targeting. In terms of a reappointment of our current chairman or an appointment of another individual to that post, to the extent that we find the markets are concerned, unstable for whatever reason, it is our job that you have given us to try to offset and stabilize that market disturbance, regardless of where it comes from.

Mr. COOPER. Do the Federal Open Market Committee actions extend to contacting the White House, or any other publicity mechanism to alter their behavior pattern in regard to news releases or things of that sort?

Mr. MARTIN. No, sir, not to my knowledge.

Mr. COOPER. So the only tools you would use would be monetary tools having to do with bank reserves or your normal mechanisms? It wouldn't have anything to do with the press releases issued by the Federal Reserve or the White House or another part of the executive branch?

Mr. MARTIN. We, in our press activities, of course, are careful to review on a very frequent basis the given actions of the Federal Reserve Board as it acts with regard to regulation of bank or holding company powers, or the approval or disapproval of particular applications that have some significance.

We issue, after a lag time, the minutes of the FOMC itself. We, of course make known our position on various issues primarily through the Chairman, as our spokesman, in his speeches and other communications which are carried heavily in our press releases. But we are not in a position to speak for the FDIC or White House or this committee or any other body.

Mr. COOPER. The Federal Reserve would seem to have an interest in the continuity of its policies. The closer we get to August, the less appearance of continuity there will be to the financial markets. If we could arrange a transition now that would have a great deal more continuity, it would seem then one that comes at the 11th hour at the end of July or August. So it would seem the Fed would have a definite institutional interest in continuity.

I was just wondering what efforts had been taken in that regard.

Mr. MARTIN. No efforts that I know of.

Mr. COOPER. Another area of interest to me is the various measures of unemployment. As I understand it, you can have U-1 all

the way to U-7, depending on how the Labor Department, Bureau of Labor Statistics, wants to measure it. The Fed seems to have a great service to the American people by educating us on M1, M2, M3.

I was wondering if there was any educational drive to educate us on unemployment, too, because, as I understand it, the Fed often uses the U-4 or U-5, where if you wanted you could use the U-7, which would be larger; or, on the other hand, you could use the U-1 or U-2 figure, which would be dramatically smaller.

But there is a lot of evidence from the questions today as to what is structural, what is not. I think it would be helpful if the Fed would consider perhaps doing for unemployment what they have already done for monetary aggregates.

Mr. MARTIN. We would be glad to submit to you, Mr. Cooper, any comments we can on those various measures.

[In response to the request of Congressman Cooper, the following information was submitted for the record by Vice Chairman Martin:]

Vice Chairman Martin subsequently submitted the following information for the record:

In response to your inquiry about the various unemployment indicators, U1 through U7, I would point out that the Bureau of Labor Statistics (BLS) reports these figures each month in its press release on the employment situation. On release of the labor market data each month, the Commissioner of the BLS, Dr. Janet L. Norwood, testifies before the Joint Economic Committee. The Commissioner is responsible for the preparation of the data and is the best qualified person to provide information on how the data are assembled and how the U1 through U7 measures relate to other indicators of labor market conditions.

I am attaching an article written by former-Commissioner Julius Shiskin for the February 1976 Monthly Labor Review, which is published by the BLS. The article provides background information on the U1 through U7 measures.

Employment and unemployment: the doughnut or the hole?

A discussion of the relative merits of various types of employment and unemployment rates as measures of the economy's performance and as cyclical indicators

JULIUS SHISKIN

The Employment Act of 1946, one of the landmark pieces of legislation in the history of our country, specifically provides that ". . . it is the continuing policy and responsibility of the Federal Government to use all practicable means . . . for creating and maintaining . . . conditions under which there will be afforded useful employment opportunities . . . for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power." Among these goals, the one which has probably received the greatest attention over the three decades since the passage of this legislation is that of maintaining maximum employment. This attention has been magnified in the past year as unemployment rose to record levels last spring before showing some improvement in recent months.

The recent recession has also heightened public awareness of the fact that, while there has been widespread agreement on the need for full employment, there has been little agreement on just what full employment is, how unemployment should be defined, or on what specific data should be used in judging the performance of the economy. There is even disagreement on whether the focus should be on the employment or unemployment statistics. The media —as well as the professional literature—have focused mostly on unemployment. This has led analysts who believe the emphasis should be placed on employment to entitle the debate as "the doughnut or the hole?" [1]

More specifically, it is the problem of measuring employment (the doughnut) and unemployment (the hole)—and the use of these measures in assessing economic performance—with which this article is concerned. Unemployment and the problems associated with its measurement are discussed first, because this area has received the most attention over the years; a discussion of measures of employment, which has recently received more intensive study and analysis, follows.

Julius Shiskin is Commissioner of Labor Statistics. An earlier version of this article was the basis of Mr. Shiskin's speech to the Metropolitan Economic Association in New York City on Dec. 11, 1975.

Measures of unemployment

While both the developers and users of labor force statistics agree that no single unemployment measure can serve all the purposes for which such data are needed, there is much diversity of opinion about the most appropriate overall measure. The reason is that the unemployment figures are used by many persons for different purposes. Many use them to assess cur-

rent conditions and short-term prospects, that is, as a cyclical indicator. Others use the data as a measure of how well the economy relieves the economic and psychological hardships experienced by jobseekers. But judgments as to what constitutes hardship arising from unemployment vary greatly among different political, social, and economic groups. Some view economic hardship in terms of the three basic elements of food, clothing, and shelter; others consider it in terms of relative standing in the income distribution, with all persons who fall in, say, the lowest one-fifth of the range classified as experiencing economic hardship. Still others consider those unemployed with adequate income from sources other than employment to be experiencing psychological hardship if they cannot find a job and, therefore, are denied an opportunity for a fuller life in some sense. Further, many believe long spells of unemployment for teenagers to be especially damaging to their development as responsible members of society.

This problem should also be approached from the viewpoint of economists, who are concerned with the overall performance of our economy in achieving vigorous economic growth. Looked at in this way, a measure which is geared strictly to economic hardship will necessarily be too narrowly based to give a good picture of the total, immediately available labor supply. Conversely, a measure which attempts to reflect the sum total of the underutilization of all potential manpower resources will undoubtedly include many persons with fairly comfortable levels of living.

Thus, no single way of measuring unemployment can satisfy all analytical or ideological interests. To meet the multiple needs of data users, the Bureau of Labor Statistics regularly publishes a wide variety of unemployment rates and indicators in its Employment Situation press release and the monthly publication, *Employment and Earnings*. It also publishes separate data on persons involuntarily working less than full time and on discouraged workers, which can be added to the figures on the unemployed by those who wish to do so. In general, it can be said that these published statistics are not specifically designed to measure economic hardship, but rather derive from an activity concept in which persons working are considered to be employed, persons looking for work are unemployed, and persons doing neither are not in the labor force at all. Finally, a distinction must be made between the use of the various unemployment series as cyclical indicators and as measures of the economy's performance.

Table 1 presents a grouping of unemployment indicators, or categories of the unemployed, identified by the symbols U–1 through U–7, which carries the process of presenting the unemployment statistics one step further. This relatively small array of unemployment measures illustrates a range of value judgments on the hardship that is experienced by the unemployed, going from a very narrow to a very broad view.[4] Others could, of course, make their own selection of such indicators. The data compiled by the BLS make it possible to construct a very large number of different measures of unemployment. The ones presented here were chosen because they are representative of differing bodies of

Table 1. Range of unemployment indicators reflecting value judgments about significance of unemployment, 1974–75

(Percent)

U–1 through U–7	Annual averages		Seasonally adjusted data	
	1974	1975	October 1973 (cyclical low month)	May 1975 (cyclical high month)
U–1 Persons unemployed 15 weeks or longer as a percent of total civilian labor force	1.0	2.7	0.9	2.7
U–2 Job losers as a percent of civilian labor force	2.4	4.7	1.7	5.1
U–3 Unemployed household heads as a percent of the household head labor force	3.3	5.8	2.7	6.1
U–4 Unemployed full-time job seekers as a percent of the full-time labor force (including those employed part time for economic reasons)	5.1	8.1	4.1	8.5
U–5 Total unemployed as a percent of civilian labor force (official measure)	5.6	8.5	4.7	8.9
U–6 Total full-time job seekers plus half part-time job seekers plus half total on part time for economic reasons as a percent of civilian labor force less half part-time labor force	6.9	10.3	5.9	10.9
U–7 Total full-time job seekers plus half part-time job seekers plus half total on part time for economic reasons plus discouraged workers as a percent of civilian labor force plus discouraged workers less half of part-time labor force	7.7	11.5	6.6	12.0

NOTE: Reflects recent revisions of basic data, including seasonal experience through December 1975.

opinion about the meaning and measurement of unemployment, because they are meaningful and useful measures in their own right, and because they can generally be ranked along a scale from low to high.

No approval or disapproval of the value judgments implicit in the selection of these series is intended here. All series are regularly published by the BLS with the exception of U–6 and U–7, and in these cases the components are published, so they can easily be calculated by anyone who wishes to do so.

The first series, U–1, is the number of persons unemployed 15 weeks or longer as a percent of the civilian labor force. The rationale behind the selection of this series is the belief that unemployment is a more severe problem when it has lasted long enough to cause substantial financial hardship. The assumption is that shorter periods can be handled by unemployment compensation plus the use of savings and, in some cases, assistance from other family members.

The second series, U–2, is the number of persons who lost their last jobs, taken as a percent of the civilian labor force. The implication of this series is that unemployment is more serious for experienced workers, for whom the loss of a job leads to significantly lower income. Here unemployment which accompanies entry or reentry into the labor force and voluntary job-leaving would appear to be considered an inevitable but less serious matter.

U–3 is the number of household heads unemployed as a percent of all household heads in the civilian labor force. In this case, it is assumed that unemployment is more serious when it affects breadwinners. Other jobseekers, secondary workers, would presumably be supported by the heads of households while seeking employment.

U–4 is the number of unemployed persons seeking full-time jobs, as a percent of all those in the full-time labor force (including those employed part time for economic reasons). The assumption here is that a measure which is limited to those unemployed who are strongly attached to the labor force is more meaningful than one which also includes more casual and marginally attached workers. Unemployment is likely to be more serious for full-time than for part-time workers because the former are more likely to be breadwinners, will lose more income through inability to find work, and are more committed to the labor force.

U–5 is the official, regularly published unemployment rate for all workers age 16 years and over. This series represents the total number of persons not working but available for and seeking work, as a percent of the civilian labor force. It can be viewed as the base series from which each of the other six series discussed in this article is constructed through the addition or subtraction of various labor force and unemployment components. In a sense, this series reflects a consensus among the many different user groups; it involves no value judgments regarding a person's family or marital status, relative need for work, or personal characteristics. It only requires that jobseeking take place. It has had widespread support from various study groups and was recommended by the Committee to Appraise Employment and Unemployment Statistics (Gordon Committee) established by President Kennedy in 1961.

U–6 includes, as a percent of the labor force, the number of unemployed persons seeking full-time work, plus one-half of the number of unemployed persons seeking part-time work and one-half of the number of those involuntarily on part-time work schedules but desiring full-time employment (with the part-time labor force given only half weight). The rationale behind this series is that involuntary part-time workers should be counted as at least partially unemployed, and their loss of working time should be reflected in the overall measure. Similarly, it is felt that unemployed persons seeking only part-time work should be given only half weight because their employed counterparts—those employed part time voluntarily—work about half a full-time workweek; the voluntary part-time employed are also given half weight. (This indicator is comparable to the "percent of labor force time lost" series, which *is* regularly published.

The final series, U–7, is the same as U–6 except that the number of discouraged workers is added to both the unemployed and labor force components. This series is based on the idea that the situation of discouraged workers is essentially the same as that of the unemployed—they are jobless, want work, and presumably are available for work. The only difference is that they are not looking for jobs because they believe no work is available for them. It should be noted, however, that specific information regarding their work history and prior job-search activity is not now collected, and many of them could be reflecting only a casual interest in entering the labor market or maintaining an unrealistic desire for a prestigious job paying a high salary.

82

As can be seen from the foregoing discussion, the data available from the BLS allow interested persons to construct unemployment series that range from those using very narrow definitions of unemployment to those based on extremely broad criteria. The series selected depends largely on the particular use to which one wishes to put the data, and on the attitudes held concerning the nature and severity of unemployment.

In table 1, the 1974 and 1975 annual average values for each of the series U–1 through U–7 are shown along with the values for the cyclical high and low months of the recent recession. In 1975, as the table indicates, the series ranged from a low value of 2.7 for series U–1 to a high of 11.5 for series U–7.

Each of the series is also plotted on chart 1 on a quarterly basis from 1953, or the first year the data for a particular series are available, through the fourth quarter of 1975. The chart clearly illustrates the successively higher percentages of unemployment reflected by each of the series.

Measures of employment

We now turn to the employment statistics, to consider two alternative employment measures and the information that they provide for economic analysis and interpretation.

First, it should be pointed out that the employment figures have numerous statistical advantages over the unemployment figures.

Under the survey procedures, every person 16 years or over in the civilian noninstitutional population is classified as employed, unemployed, or not in the labor force. With few exceptions, a person who during the survey week did any work at all for which he or she was paid is considered to be employed. Persons are unemployed if they did not work at all during the survey week, were available for work, and actively tried to find work during the past 4 weeks. All others are classified as not in the labor force.

Employment, therefore, is a firmer and more objective concept than unemployment; consequently, it is easier to define and measure. In measuring unemployment, uncertainties can arise, such as in the determination of whether jobless persons are actively seeking work or whether they are currently available for work. The identification of employment, on the other hand, is relatively straightforward.

Next, employment, a much larger figure than unemployment, is subject to a relatively smaller measurement error. To illustrate, in the fourth quarter of 1975 there were 85.4 million employed and 7.8 million unemployed.

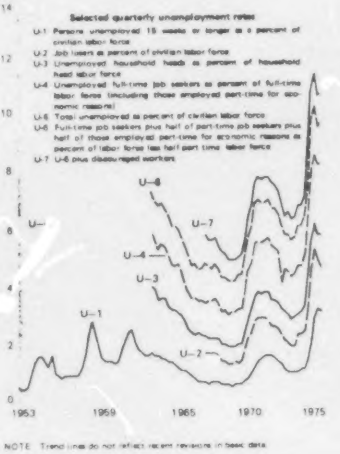
Additionally, the seasonal adjustment of employment is more accurate than that of unemployment. The reason is that seasonal changes in total employment are relatively small, as are changes in the level from one period to another. In contrast, unemployment is subject to large seasonal swings as well as dramatic changes in level over short periods of time. As a result, the multiplicative seasonal adjustment method, which BLS uses and which has almost always worked well for economic series, introduces distortions into the seasonally adjusted unemployment series when the level changes dramatically. There are no similar problems in adjusting the employment series.

The employment series is not without statistical and definitional problems, however. Some analysts believe allowances should be made for part-time workers, underutilized workers, and workers with earnings below the poverty threshold.

Employment-labor force ratio. The first employment measure to be considered is the employment-labor

Chart 1

Unemployment indicators, 1953 through 1975


Rate
14
12
10
8
6
4
2
0
Selected quarterly unemployment rates
U-1 Persons unemployed 15 weeks or longer as a percent of civilian labor force
U-2 Job losers as percent of civilian labor force
U-3 Unemployed household heads as percent of household head labor force
U-4 Unemployed full-time job seekers as percent of full-time labor force (including those employed part-time for economic reasons)
U-5 Total unemployed as percent of civilian labor force
U-6 Full-time job seekers plus half of part-time job seekers plus half of those employed part-time for economic reasons as percent of labor force less half part-time labor force
U-7 U-6 plus discouraged workers
U-8
U-7
U-6
U-4
U-3
U-1
U-2
1953
1959
1965
1970
1975

NOTE: Trend lines do not reflect recent revisions in basic data.

force ratio, or the percentage of the civilian labor force that is employed. Thus, it is simply the complement of the familiar total unemployment rate. It provides a measure of actual employment as a percentage of that part of the population which has met the market test of working or actively seeking work.

Despite the use of a more solid figure in the numerator, the advantages of the employment-labor force ratio over the unemployment rate are dubious. The major public concern lies with trends in unemployment. The reason that a series such as the jobless rate is constructed in the first place is to focus on a problem. This is similarly true for statistics on illness, crime, poverty, and other areas. Thus, public attention has not been directed to the percent of people in good health, of those who have escaped crime, or of those who are above the poverty threshold. Rather, attention is centered on the percent of persons who are ill, who have been victims of crime, or who have incomes below the poverty level. And such statistical series are compiled to provide data for those concerned with social or economic problems.

Although BLS receives occasional requests that the employment-labor force ratio be featured in press releases and public discussions, this measure has not received widespread acceptance for use as an economic or social indicator. The ratio itself is not regularly published by the Bureau of Labor Statistics, but it can easily be calculated by subtracting the unemployment rate from 100.

Employment-population ratio. Another employment measure, and one which seems to be more useful than the employment-labor force ratio, is the employment-population ratio. It is derived by dividing the total civilian employment by the civilian noninstitutional population age 16 years and over.[3] It is a measure of employment as a percentage of the population, which is the group that is available for work in the broadest sense. This kind of measure was suggested to BLS in March 1970 by Professor Milton Friedman of the University of Chicago and had been used by some labor market analysts during the previous decade.[4] It has been published by the BLS in *Employment and Earnings* on a quarterly basis since April 1973. Monthly data are published in that periodical for the total employment-population ratio only, but the data needed to calculate the major age–sex ratios are also published there. All of these data are also published quarterly in the BLS press release, Labor Force Developments. (See chart 2.)

For certain purposes of economic analysis, the employment-population ratio may provide a better measure of labor market conditions than either the unemployment or employment rate, which use the civilian labor force as the base. The reason is that the labor force itself may expand or contract in response to changes in the pace of economic activity, in contrast to the greater stability of the population.

To the extent that persons leave the labor force during an economic decline—that is, lose their jobs and do not seek others—the reduction in employment will exceed the increase in unemployment. Similarly, if there is a rapid growth in the labor force during the expansionary phase of the business cycle, employment will increase more than unemployment will decline—that is, persons enter and reenter the job market at the same time that many job losers return to work. The potential expansion and contraction of the labor force is illustrated by the data which show that more than 10 million out of a total of about 59 million persons not in the labor force during the fourth quarter of 1975 worked at some time during the preceding 12 months. Most of those leaving the labor force were housewives and students, who wanted only seasonal or other temporary work, and older persons who retired or left because of disability. About 700,000 workers were squeezed out because of slack in the economy; about two-thirds of them were women.

Further perspective on the potential expansion of the labor supply is provided by the data on discouraged workers. In the fourth quarter of 1975, about 1 million persons reported that they wanted jobs but did not seek them because of discouragement over job prospects. Two-thirds of this group were women. A larger group, 4.3 million persons, reported that they wanted jobs but did not look for them for a variety of reasons, such as school attendance, family responsibilities, or illness. Some of these nonparticipants might be drawn into the labor force if jobs suddenly became readily available, even at a relatively low wage. These groups not in the labor force represent a reserve which could substantially shift the size of the labor force under changing economic conditions—for example, in the event of a Federal job guarantee program or the elimination or reduction of the Federal minimum wage for teenagers.

The behavior of the labor force in the current

recovery appears to be somewhat different from that of earlier recoveries. In the past, the labor force has grown very little during the first 9 months or so of cyclical recoveries. During the first 9 months of the current recovery (dating from March 1975), labor force growth has been substantial—1.2 million, compared with the median path of virtually no growth in prior recessions. There are several plausible explanations for the larger than usual cyclical growth in the labor force during 1975. According to one theory, it reflects the changing role of women in society; in fact, adult women have accounted for about half the above-normal cyclical growth this year. Another hypothesis is that the combination of inflation and unemployment has put severe financial pressure on many families and induced an unusually large number of family members to seek jobs. Still a third possible reason advanced is that some people who otherwise might have left the labor force may be staying in because of the extension of unemployment insurance benefits. Eligibility for these payments requires the beneficiary to be seeking work. In any case, and for various reasons, we have seen an unusual cyclical growth in the labor force during the recovery in 1975.

Thus, while the unemployment rate is potentially subject to wide variations as a result of special developments leading to growth or contraction in the labor force, the employment-population ratio includes a more stable base for a measure of labor market activity, one that is undisturbed by the shifts of workers into or out of this labor force.

There are measurement problems in estimating monthly population totals, but these are relatively minor, especially for age groups 16 years and over. A more serious problem is that there are no comparable population figures upon which to base trends in full- or part-time jobs, as well as in employment by occupation or industry.

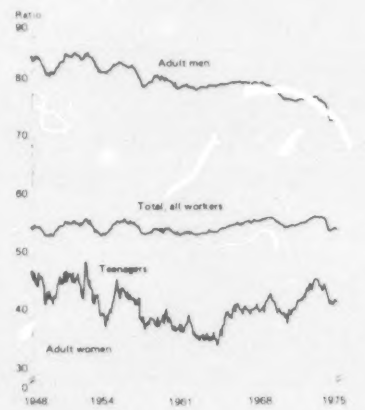
Since about 1948, the employment-population ratio appears to have held about steady, except for a slight upward tilt from 1970 to 1974. (See chart 2.) However, this overall trend masks important changes in the age-sex composition of the ratio over this period. The ratio for adult men has trended gradually downward, primarily in line with increasingly early retirement. On the other hand, there has been a pronounced secular increase in the ratio for adult women over this period. Teenagers showed a dual pattern over the period, as their ratio declined between 1948 and 1964 and rose in the subsequent decade. Trends in an aggregate, made up of components which are moving in different directions, are difficult to interpret. Furthermore, aggregate employment is a simplistic measure which does not take into account variations in skills, earnings, and hours of work. Hours of work may be especially important in this context in view of the increasing proportion of part-time workers in the labor force over the last two decades. A more sophisticated measure, taking such factors into account, might reveal a different trend.

Like other economic indicators, the employment-population ratio should be used in conjunction with the broad range of indicators of labor market activity currently available in order to develop a balanced and accurate picture of actual labor market conditions. It should be noted, for example, that an expansion in the labor force could result in an increase in both the employment-population ratio and the unemployment rate. The two measures, examined together, can be more revealing of underlying labor market developments than can either measure by itself.

It is important, as it is in assessing any economic

Chart 2.

Employment-population ratio by age and sex, seasonally adjusted, 1948-75



index it, to be wary of using one number without any breakdowns, as has been done by some advocates of the employment-population ratio. The BLS has repeatedly stressed in the analysis of its unemployment statistics the importance of using the wide range of detail available in order to make a sound judgment of what the underlying economic conditions are. It is equally important that this be done with the employment-population ratio. Finally, it is important to continue research into the historical and current behavior of this ratio and its many components. The Bureau of Labor Statistics will try to do further research on this subject, within the limits of our research resources, and we encourage others outside the Bureau to do further work in this area as well.

Ratio and unemployment rate compared

It is useful to distinguish between a "cyclical indicator" and a "measure of performance," as already noted in the opening section on unemployment. A cyclical indicator shows what stage of the business cycle the economy is in or what stage it is likely to be in next. Thus, "coincident" indicators describe the current cyclical stage, and "leading" indicators, the stage that is likely to be reached in the period immediately ahead. The classification of economic indicators according to the sequence in which they move over the business cycle can be carried out in a reasonably objective way. On the other hand, measures of performance of the American economy reflect value judgments on the goals of economic policy—for example, high employment (or low unemployment) and stable prices. The distinction between cyclical indicators and measures of performance is emphasized by the fact that neither the unemployment rate nor the Consumer Price Index, two principal measures of economic performance, are included in the new National Bureau of Economic Research (NBER) short list of cyclical indicators. (It is also to be noted that the new NBER short list omits real gross national product (GNP), the most comprehensive measure of economic output and one of the most important measures of economic performance, because it is not available monthly.)

In its assessment of cyclical indicators, the NBER has devised a method of assigning to them numerical scores, or weights, ranging from 0 to 100. The scoring plan covers six major elements: economic significance, statistical adequacy, historical conformity to business cycles, cyclical timing record, smoothness, and promptness of publication. The ratings throw into clearer perspective the characteristic behavior and limitations of each indicator as a tool in short-term economic forecasting.

When the employment-population ratio is tested by these standards, it comes out with a score of 76, compared with 87 scored by the top cyclical indicator, nonagricultural payroll employment. The principal reason for its lower score is that the employment-population ratio has a poor cyclical timing record at business cycle peaks. Consequently, the employment-population ratio could not be classified as leading, coincident, or lagging at business cycle peaks, and it lagged at business cycle troughs. In addition, this series is fairly erratic over the short-run and, therefore, receives a relatively low score for smoothness. For these reasons, the employment-population ratio did not qualify for inclusion on the NBER short list of cyclical indicators. The total unemployment rate received a slightly higher score—78—but did not qualify for the new short list because of differential timing at peaks (led) and at troughs (lagged). While neither the unemployment rate nor the employment-population ratio was selected for the new NBER short list, they both scored fairly high. The unemployment rate, in particular, must be rated as a good cyclical indicator. If the fact that

Table 2. Cyclical trends in the unemployment rate and the employment-population ratio since 1945

Business cycle dates (trough to trough)	Duration (months)	Unemployment			Employment-population ratio		
		Cyclical average	Cyclical high (3-month average)	Cyclical low (3-month average)	Cyclical average	Cyclical high (3-month average)	Cyclical low (3-month average)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
October 1945–October 1949	48	4.7	7.0	(1)	56.1	56.9	55.3
October 1949–August 1954	58	4.0	5.9	2.5	56.7	57.9	55.1
August 1954–April 1958	44	4.6	7.4	3.8	56.8	57.7	55.3
April 1958–February 1961	34	5.9	7.0	5.1	55.9	56.4	55.2
February 1961–November 1970	117	4.7	6.0	3.4	56.5	58.0	56.5
November 1970–March 1975	52	5.6	8.9	4.7	57.2	58.1	55.9

[1] Data are not available prior to January 1948; therefore, averages are computed for the period January 1948 to October 1949.

[2] Not available.

NOTE: The high and low dates used to compute the values shown in cols. (4), (5), (7), and (8) are those for the specific series rather than the general business cycle turning dates designated by National Bureau of Economic Research. The 3-month average is the mean of the high or low month, the month preceding the high or low month, and the month following the high or low month.

it leads at peaks and lags at troughs is borne in mind, it can be put to good use in cyclical analysis.

The unemployment rate and the employment-population ratio must both receive high ratings as measures of performance (along with real GNP and the Consumer Price Index). With this standard in mind, it should be noted that the unemployment rate reached a very high level over the course of the most recent business cycle and attained a postwar record during the 1974–75 recession. While the employment-population ratio showed a sharp drop during the recent recession, it had also indicated prior to the downturn that a slightly larger percentage of the U.S. population has been working during the past 5 years or so—the most current complete cycle—than in previous postwar cycles. (See table 2 and chart 2.) Further, the average for the full 1970–75 business cycle is higher than for any previous business cycle. Also, in terms of the goal of promoting maximum employment, the employment-population ratio would appear to give a higher rating with respect to the performance of the American economy during the 1970's than the unemployment rate.

How can these apparently contradictory trends be explained? The answer appears to be that there are changes in the labor force participation rate—a greater percentage of the population wants to work than in the past. Thus, a greater percentage of the population is in the labor force, both as employed and also as unemployed.

For the present, we can say that the employment-population ratio and the unemployment rate are both useful cyclical indicators, though neither ranks among the very best. However, both measures rank close to the top as measures of performance. Both illuminate different aspects of labor market conditions, and both are necessary for a balanced view of the overall employment situation. Thus, I would say the answer to the question, "the doughnut or the hole?" is the doughnut *and* the hole. □

———*FOOTNOTES*———

ACKNOWLEDGMENT. The author is heavily indebted for advice and assistance to Robert L. Stein, John E. Bregger, Myrtle Nelson, and John F. Stinson, all of the Bureau of Labor Statistics.

[1] See, for example, the remarks by former Commissioner of Labor Statistics Geoffrey H. Moore in "A Measuring Stick of Employment," *The Wall Street Journal*, May 9, 1975, in "On the Reliability of Employment Figures," a letter to the editor of *The Washington Post*, July 25, 1975, and in "The Numbers Aren't Everything," *The New York Times*, Oct. 2, 1975. See also the analysis by Irwin L. Kellner, vice president and economist of the Manufacturers Hanover Trust Co., "Counting the Employed, not the Unemployed," *The New York Times*, Oct. 26, 1975.

[2] An array of unemployment indicators similar to the M–1 through M–7 series used by the Federal Reserve to describe successively more comprehensive definitions of the money supply was suggested to the author by Dr. Otto Orenstein of the Hawaiian Telephone Co. in Honolulu. The selection of series U–1 through U–7 included in the list was made by the BLS. While this list uses symbols for the unemployment series analogous to those used by the Federal Reserve, with each higher numbered series representing a slightly higher level of unemployment, it does not have the elegant property of representing successively broader definitions of unemployment compiled by adding groups at each higher level.

[3] The Bureau of Labor Statistics excludes the Armed Forces figures from both the employment and population series. However, the data regularly published in *Employment and Earnings* enable analysts to compute an employment-population ratio in which the Armed Forces are included in the employment total as well as in the population figure if they so desire.

[4] A letter to Commissioner of Labor Statistics Geoffrey H. Moore from Professor Milton Friedman of the University of Chicago, dated Mar. 9, 1970. There were numerous earlier uses of the employment-population ratio. For example, see T. Dernburg and K. Strand "Hidden Unemployment, 1953–62," *American Economic Review*, March 1966, pp. 71–95; Jacob Mincer, "Labor-Force Participation and Unemployment: A Review of Recent Evidence," in Robert A. Gordon and Margaret S. Gordon, eds., *Prosperity and Unemployment* (New York, John Wiley & Sons, 1966), ch. 3; K. Strand and T. Dernburg, "Cyclical Variation in Civilian Labor Force Participation," *Review of Economics and Statistics*, November 1964, pp. 378–91; Alfred Tella, "The Relation of Labor Force to Employment," *Industrial and Labor Relations Review*, April 1964, pp. 454–69; and Alfred Tella, "Labor Force Sensitivity to Employment by Age, Sex," *Industrial Relations*, February 1965, pp. 69–83.

Mr. COOPER. I think a submission to the general public would be of the greater interest.

One final question is this. I would like for you to answer it as private citizens, if possible. You urge fiscal restraint on the part of Congress to lower budget deficits. I agree with you.

I was just wondering if, as private citizens, what you thought a potential tax increase might do to the recovery?

Mr. MARTIN. I think it would be unseemly for me as a Federal Reserve official to comment on or to attempt to advise the Congress on something that is the Congress' particular responsibility.

Mr. COOPER. How about unofficially, then, as a private citizen, Mr. Martin?

Mr. MARTIN. I think as a private citizen I have biases, as any other private citizen has. And those are that, if the Congress moves toward the tax increases, I would hope there would be careful consideration of taxing consumption and consideration of the effects that taxing investment could have on our needs for building the capital stock.

I guess my biases would go in the direction of attempting to preserve whatever is possible of incentives to invest and create new jobs. But that is a private citizen's bias.

Mr. COOPER. Mr. Keehn?

Mr. KEEHN. Well, it seems to me, speaking as a private citizen, that any increase in taxes at this particular moment, given the status of the recovery, would not be appropriate. Having said that, we have this longer run fiscal problem that simply has to be dealt with.

I think it will take a very careful balance between increased taxes to raise revenues and decrease expenditures to aid on that side. I think we have accomplished something in the tax policy to provide incentives to save, and I would hope we would not make a change there but, rather, consider very carefully the applicability of taxes that would be on the consumption side.

Mr. COOPER. Thank you very much, Mr. Chairman.

Chairman FAUNTROY. I thank you.

The gentleman from Delaware, Mr. Carper?

Mr. CARPER. Thank you, Mr. Chairman. I would like to welcome both of our panelists today.

Mr. KEEHN. Thank you.

Mr. CARPER. I would like to follow up, if I could, on my colleague from Tennessee's question. One of the alternatives, in fact, a couple different tax alternatives or revenue enhancers have been proposed to the Congress earlier this year. One by the President, I think a prospective fee, if you will, on maybe imported and/or domestic oil. Also, we have heard some talk about rescinding the third year of the tax cut or some variation of a change in the tax cut.

One of the ideas that has some appeal is that of capping the tax cut, the third year of the tax cut, at some nominal tax cut per individual, $700, $500, $300. You pick the number.

Two questions, both closely related. Would you care to comment, please, on what impact the imposition of a fee on domestic and/or imported oil might be expected to have on inflation and on our economic recovery. And secondly, what impact might the enactment of a change in the third year of the tax cut; that is, a $700 cap on the

magnitude of that tax cut, how might that also impact on the rate of inflation and, more particularly, the economic recovery?

I don't know if I should ask you to do this with your official hats on or your taxpayer capacity. Whichever you feel most comfortable in.

Mr. MARTIN. I must admit I have not done or reviewed work in this area of the impact of individual taxes through any kind of modeling process. So I am at a loss really to respond in any very technical way. I am aware of the arguments that have been made in various European countries for the taxation of imported oil, and indeed the moves that have been made in some countries to attempt to try to hold up the price, with taxes, at the gas pump in an effort to restrain the consumption of that particular need-to-be-imported commodity.

It seems to me that that is worth looking into in our own case. I am aware of the discussions here in the Congress on that. But I must confess, I do not have data or any opinion that would be of weight to this committee with regard to the third year tax or the cap.

Mr. CARPER. Mr. Keehn?

Mr. KEEHN. With regard to the second question, I would want to know the facts as to what a cap on the tax cut would really mean in terms of revenue. If the facts were such that it would result in a substantial amount of money, then it would be worth considering.

Mr. CARPER. Let us assume for the moment a $700 tax cut would raise from $5 to $10 billion in fiscal year 1984.

Mr. KEEHN. I would be surprised if the number were that large, but if it were that large, it would certainly be something you would have to consider very carefully.

On the first question with regard to oil import fees, it seems to me that the price of oil has dramatically declined; the price of energy has dramatically declined. This might be an opportunity—again it relates to the comment I made a moment ago with regard to consumption taxes—since a tax on oil imports is basically consumption oriented. It would be a way in which this could be accomplished. At the same time, and certainly not incidentally, it would provide an opportunity for the increase of domestic production, and that has a whole series I think, of, beneficial effects.

Again I would want to look at the numbers very carefully. But if it was an interesting number, it is something I would want to think about very carefully.

Mr. CARPER. Thank you. Next question: As the economy recovers this year, and hopefully next, what factors will be acting to one, rekindle inflation, and two, to moderate or dampen the rekindling of inflation? It is a two part question. That is the first part.

Mr. MARTIN. Well, the rekindling of inflation is an ever present and major danger. As the Congressman knows, prices have begun to firm in areas in which demand is growing. For example, the first sector of our economy to show broad recovery has been housing. I understand the price of new housing at the sales market level has already begun to float up some. This, after less than 12 months of recovery in housing.

Second, we are all aware that sensitive commodity prices and certain raw materials such as lumber, have already shown, particu-

lar.e where discounting was severe during the recession, substantial increases. Some lumber prices being quoted now are 40 to 50 percent higher than they were 12 months ago.

I think we have to be careful to sort out in reviewing these price increases, the potentially alarming implications that this data has for inflation from the aspects of the increases that indicate a recovery in prices for raw materials, commodity and semifinished goods that is necessary to bring production back up to a break-even point. Copper mines, in which the price is only a fraction of the cost of production, of course, there are going to be some increases in copper.

The more fundamental question, though, that should be in everyone's mind is, as the economy recovers, are there wage and price increases that are expectational in nature? That are anticipating shortages? That are anticipating higher prices in the future? To date, there has not been much of that. It is the anticipatory side of wage settlements and of contract renegotiation between vendor and user that so far have not shown a lot of this really alarming leading indicators.

Mr. CARPER. Mr. Keehn?

Mr. KEEHN. I think I would divide the risk into two broad categories: first, wage escalation, and second, price escalation. Dealing with the second one first, I think one of the more interesting developments that has come out of this recession is the very substantial reduction in break-even levels by a lot of our operating industries. It has been accomplished in a number of ways, but among others, as I suggested in my testimony, a significant number of plants have simply been closed down. The productive capacity in many of our basic industries has been very significantly reduced.

As we get into the recovery and as operating ratios go back up from what is currently a very low level, there is going to be a temptation on the part of industry to bring back some price increases. We are already seeing this. The vice chairman has commented on a number of commodities where you are seeing price increases. I think you will see this following through into product prices. As the operating ratios go back up, I think you are going to see a snugging up of prices. Not so much overt price increases as the elimination of discounts from list and that type of thing.

The other area, the other side, wage escalation, I think as we go forward into negotiations, bargaining sessions and the like as corporate profits improve, I think labor will want to regain some of the concessions that they have given up. I think labor will also want to try to increase some of their demands in the bargaining process.

These two areas, wage escalation and price escalation, are the risks that I would see. Both would be considerably influenced by the outlook for inflation and inflationary expectations. If, in fact, on the wage side and the price side people have an optimistic outlook with regard to inflation and can count on continued price stability, I think their attitude in these two areas will be different.

Mr. CARPER. Thank you. My time has expired. On the second round I will come back with the second half of my two part question. I will give you a little signal. I am going to be asking you, of those factors enhancing or depressing inflation over which does the

Fed have some control, and over which does the Congress have some control?

Chairman FAUNTROY. Mr. Martin, there have been persistent questions as to the type of recovery that the Fed would like to see happen. On the one hand the Fed could be trying to foster recovery with real growth in the first year or so comparable to past recoveries—6 to 7 percent—even at the risk of a modest rebound of inflation from the current 3- to 4-percent rate. On the other hand, the Fed could be trying to foster a recovery with a slower rate of real growth the first year or so—say about 5 percent—in order to hold inflation at those rates. Since the choice of these two courses obviously has implications for employment, I wonder if you would tell the committee which of these kinds of recovery the Federal Open Market Committee, and you personally, would like to see happen. Specifically, if real growth this year turns out to be 6 to 7 percent, would the Federal Open Market Committee view that rate as an overheated expansion which should be restrained or as an appropriate or proper response?

Mr. MARTIN. Mr. Chairman, a 6 or 7 percent real growth for this calendar year would be one in which I think we all as citizens would applaud. A 6- or 7-percent real growth would mean, I think, that unemployment would decrease more rapidly than the numbers we were previously reviewing. If 6 or 7 percent could be accomplished while inflation was kept within the 3 to 4 percent range, it would seem to me that that would be a very salutary outcome.

I think our problem is that the economy has a momentum of its own that is affected by monetary policy, affected by fiscal policy, affected by these international developments. And we all are in a sense adjusting to what we are finding out there in the markets. We are finding a little bit stronger recovery by half a point or three-quarters of a point than some of the consensus forecasts were just a few months ago. I think it is monetary policy's job to accommodate that higher rate of recovery. And so far we have not been constrained by leading indicators of inflation's renewal, as I have testified in the previous question.

So I think my answer would be, the recovery is getting a little stronger, and it is our job to accommodate that. And so far we don't see we have to pay the price in rekindling inflation.

Chairman FAUNTROY. Mr. Keehn, you have given us, as I indicated at the outset, a pessimistic picture of unemployment, and of the employment outlook in your district. You have discussed the declining population, you have talked about business closings, and you have noted, with some emphasis I think, the demolition and disposal of factories and the role of limited public transportation. Do you foresee any bright spots in the employment picture in your district? What do you suppose could be done now?

Put another way, what advice would you give our friend, the Governor of Michigan, who previously to becoming Governor had served on this committee and chaired the Subcommittee on Economic Stabilization?

Mr. KEEHN. Well, Mr. Chairman, I am sorry that my testimony is being viewed as a pessimistic outlook. In fact, it is a rather factual assessment of conditions in the district, and really with the pas-

sage of time and some improvement in the economy we are feeling better about things out there than we certainly were a year ago.

With regard to your specific question concerning Michigan, there are some very significant imbalances, if you will, in Michigan. I have pointed out some of them in the tables and in my testimony. For example, the unemployment compensation rates are high; the workmen's compensation rates are high; the level of compensation costs are comparatively very, very high. Compensation costs are 33 percent over the national average. Just salary and just pay, not including the fringes. I think if Michigan is going to address the issue and is going to revive the State, they are going to have to look at these comparative disadvantages and begin to do something about them.

To give you a specific, Michigan has a usury law that we view as being very burdensome. It is very difficult to operate a financial institution in the State of Michigan with the usury law that they currently have in place. As a result of that, they are losing some employment. Some of the financial institutions are moving into other areas so they can operate without the effect of that usury law. These are the types of issues that we think the States are going to have to look at very carefully if they are going to try and put themselves back on an absolutely competitive basis with other areas of the country.

Chairman FAUNTROY. Mr. Martin, in your statement you stress the need for positive solutions that mitigate the dangers associated with persistent high structural deficits. Let me first say I agree with you. My concern is that folks over at the White House and Pentagon apparently don't agree. As you know, both the House and Senate have passed budget resolutions which differ in a number of details, and which will have to be worked out in conference. However, both provide for lower deficits through smaller defense increases, more social spending, and higher taxes than the administration has sought. There are currently reports that the administration is not going to cooperate or compromise in this matter but will employ the veto. Would that be, in your view, a positive solution to our problem now?

Mr. MARTIN. Well, Mr. Chairman, I think it would be presumptious of me. I can't speak for the Federal Reserve in this matter. We haven't reviewed those two alternatives, so I would have no authority to speak. I think I would be getting beyond my field of expertise if I were to respond to the chairman. I would respectfully decline to comment.

Chairman FAUNTROY. Mr. Keehn, would you care to respond to that?

Mr. KEEHN. Mr. Chairman, I really don't think I would have anything that I could add that would be useful to the committee.

Chairman FAUNTROY. Maybe I can get Mr. Barnard to respond. No

Mr. BARNARD. I would be glad to.

Chairman FAUNTROY. Mr. Hiler?

Mr. HILER. Thank you, Mr. Chairman.

Mr. Martin, I have to say that I am a little bit surprised that you either have no opinion or that you plead lack of technical expertise to respond to the question as to whether you think the third

year of the tax cut should be eliminated. I think in an earlier question, when someone asked whether it should be eliminated or capped, you said you had no opinion, or did not have the technical expertise to be able to respond to that as to what impact that would have on the recovery. You would have to be the only major policymaker in the country that has no opinion on that.

Now, certainly several times this afternoon you have told us we should get the deficit down and do these different things. This is an option. You, as an individual, as someone with an economic and banking background, must have an opinion on whether or not the third year of the tax cut should be repealed or not and what impact that would have on an economic recovery.

Mr. MARTIN. Well, I interpreted the previous question as indicating a request for a quantitative measure of what sort of impact a particular set of revenue measures would have. Not having the data, I felt I should not respond in any quantitative way. Of course, in terms of increasing taxes in any way early in a recovery, this is a kind of measure that would give any of us pause in that the recovery is in such an early stage. To increase taxes at such an early stage is a highly risky operation. And I would rather not see that kind of a measure enacted.

On the other hand, in regard to our responsibilities for setting monetary policy, we are working in markets in which the Treasury is coming to market for $10 billion one week, $12 billion another week, $15 billion another week; and those massive calls on the markets are something we are coping with on a week-to-week basis.

In the short run, I am concerned about raising taxes of any sort early in a recovery. But over the longer run in terms of a rising deficit and its management, it is a very difficult matter today.

Mr. HILER. I will interpret that as saying that you would be skeptical of the wisdom of raising taxes in this early stage of the recovery, that it could have a negative impact.

Mr. MARTIN. Yes, sir.

Mr. HILER. Let me ask the next question. While you are skeptical, the other point you mention is that the deficits are worrisome to you. I presume that probably the out-year deficits, more than the deficits in the next 6 months——

Mr. MARTIN. That is correct.

Mr. HILER. One way or another, do you view the option of raising taxes or reducing spending as having equal impact?

Mr. MARTIN. No, because we are in a low saving, low investment cycle. An incentive to invest and to create new jobs, in new enterprises and expanding existing enterprises, is very important to us in sustaining economic recovery. Therefore, it seems that there is an economic case for reducing spending as long as that can be done without adversely affecting those who truly need the welfare and support. In general, I believe that it would be preferable to reduce the spending than to raise taxes.

Mr. HILER. Let me ask then a third question. If the option is between borrowing a dollar and taxing a dollar, to eliminate a dollar of deficit that is not solved, say, by economic growth, or say to eliminate a structural deficit, or is to eliminate a deficit that is driven by higher spending, do you think those two options are of

equal impact? Do you think a dollar of tax has less impact than a dollar of borrowing to eliminate a deficit?

Mr. MARTIN. I think to borrow to eliminate the deficit may be somewhat contradictory. I think in terms of any revenue measure, its incidence very much depends on the nature of the tax. The incidence of a tax obviously would be taken into consideration by you and by others of this body in determining whether or not so to enact. But borrowing to finance an ever larger deficit, given our goals of monetary restraint, can only place a tremendous burden on private credit markets and, consequently, on business investment.

Mr. HILER. If I might just take another second here, Mr. Chairman.

Chairman FAUNTROY. Certainly, please go ahead.

Mr. HILER. I am not sure I understood your answer. It may be because you didn't understand my question. I don't know. I guess the point I was driving at is that many people view borrowing a dollar to take care of spending beyond what existing tax revenue is has a more adverse impact on the economy and credit markets than does taxing another dollar to eliminate that dollar's worth of deficit.

Do you view that to be the case, or do you think they have the same net impact?

Mr. MARTIN. I think we are talking about the impact of two policies which have to be weighted particularly depending on the state of the recovery we are in. There is an expectational side that is a little tricky, in that if the bond traders feel there are going to be very heavy outyear deficits, that is different from borrowing the dollar today. Raising taxes today, depending on what kind of a tax it is, of course, will take money out of the private sector spending stream. And therefore in the immediate short run may be injurious to a kind of an average or below average recovery.

The markets may interpret the tax, however, as meaning lower deficits out in the future, and it may have salutary effects on interest rates through expectations. So you are caught in the shortrun/longrun dilemma here.

Mr. HILER. I thank the gentleman. Yield back.

Chairman FAUNTROY. Mr. Barnard?

Mr. BARNARD. Mr. Martin, do you think we ought to have an amendment to balance the budget?

I see where the distinguished minority leader on Ways and Means is reintroducing his balance-the-budget amendment this week. Do you think we need such a stipulation in the Constitution?

Mr. MARTIN. I think that it is always appropriate to explore new ways to get at the question of controlling expenditures and furthering growth. The various proposals for constitutional amendments that have come forth have, of course, required all kinds of institutional changes and exceptions, exceptional circumstances in which the budget would not have to be balanced. I am fearful that overreliance on procedure or technique may blind us to the necessity of making the hard decisions to reduce certain kinds of spending that are not necessary to the lower income groups, and to readjust our revenue structure so as not to interfere with tomorrow's unemployment.

So I guess my concern with consideration of constitutional amendments is the fear of distracting the decisionmakers from the hard decisions that need to be made now in both sides of the income statement.

Mr. BARNARD. I was just interested to see what you would say about that little issue

The Williamsburg Summit is now concluded, and everybody has gone home happy with idealistic goals of lower interest and lower unemployment, and so forth, which means that if we are going to accomplish all of these goals with all of these industrial nations, aren't we going to have to have some similarity in evaluating some of the problems, such as, don't we have some difference in evaluating M1, M2, and M3, and setting monetary goals, as opposed to our European friends?

Mr. MARTIN. Well, I am privileged to attend meetings from time to time of the Bank of International Settlements at which other central bank representatives are there. I must say, like any other group of functionaries, we talk shop. For instance, we talk about; why is it in Canada you are not focusing on M1 hardly at all anymore? Why is it in the United Kingdom you have got three measures of the money supply, as we have, et cetera. I think that there are more similarities than differences. Once you allow for the fact that some European countries use a lot of cash and not much checkbook, the problems are quite similar.

Indeed, I must observe that in country after country the growth curve of M1 or its equivalent in Germany or United Kingdom is rather surprisingly quite similar to ours. That is, they are overtarget with it, too.

Mr. BARNARD. But they don't have the fluctuations we have, do they?

Mr. MARTIN. Yes, sir, they have very substantial fluctuations. Once allowing for all the adjustments you have to make in the growth of the aggregates, they have very substantial——

Mr. BARNARD. Is that because of the structure of their banking community there?

Mr. MARTIN. I think it is because the markets in these countries, particularly for government securities, are themselves volatile. The movement in those markets affects the deposits in the various financial institutions country by country. And they have the same variability in markets that we have in markets, and it affects the growth in their monetary aggregates as it affects our growth.

Mr. BARNARD. What do you see as Vice Chairman of the Fed as the value, the economic value, of the Summit?

Mr. MARTIN. I think it is a valuable exercise in the coming together of individuals who carry enormous responsibilities. I think there is the same merit in those meetings as there is merit in the meetings of yourself, sir, with other important senior members of other committees in the Congress. I think it is a person-to-person kind of communication that is vital.

Mr. BARNARD. I have no other questions, Mr. Chairman.

Chairman FAUNTROY. Mr. Carper?

Mr. CARPER. Thank you, Mr. Chairman.

I would like to pick up, if I could, where we left off. You may recall the two part question I was asking. The first part of the

question you both addressed was what are some of the factors that could prospectively increase or further dampen the increase in the rate of inflation.

The second part of the question I would like you to now address, if you will, is what sway does the Fed have over those factors, what sway if any does the Congress have over those factors?

Mr. MARTIN. Well, the way that the Federal Reserve influences inflation works its way through financial variables as the gentleman knows. It is our task to determine the path of the monetary aggregates and to determine the growth of credit. Our tools work through financial markets, and affect interest rates, that in turn affect money and credit flows. As each of those variables is important to the path of the economy, it influences the total inflationary situation.

If we think of our role in the context of a multiple-equation model of the economy in which the various forces and factors affecting inflation are all coming together and interacting, we have much to say about the financial factors that affect the level of economic activity. But in terms of other forces, such as the restructuring of the labor force, the retraining of workers, the mobility of human resources and physical resources from manufacturing to the service trades and activities, the work ethic, people's attitude toward productivity, there are economic forces that are outside our control. Monetary policy is an important factor in determining the path of growth of nominal income, but there is a range of uncertainty surrounding how any given monetary policy, when combined with other economic forces, will affect real growth and inflation. We make every effort to be careful that our policy is having the impact we intend.

Mr. CARPER. That addresses part of the question. That is, what factors does the Fed have sway over. How about the Congress? What do you see us as the Congress having some sway over?

Mr. MARTIN. Well, the Congress, of course, has influenced many factors. Your passing and reconciling two different budgetary resolutions immediately affects private markets as participants evaluate the potential competition for funds. Your various enactments in the deregulatory area bring competition into markets formerly protected because of statutory and regulatory bars to competition. Your's is the action or inaction with regard to the International Monetary Fund quota, to World Bank funding considerations. You influence us and the other bank regulatory agencies with regard to the controls over international lending in the future. Of course, you supervise us, so it seems to me that there is very little the Congress doesn't have under its aegis.

Mr. CARPER. All right. There have been some recent reports of significant increases in productivity in this country. I think the first quarter numbers for this year were quite encouraging compared to previous years.

To what do you attribute those changes? What impact, if any, may we look to because of those changes to, say, rates of unemployment, to the rates of inflation?

Mr. MARTIN. In responding, I would say that we are caught in the short run/long run dilemma again. I would certainly verify that the output per hour relative to 1 year ago, first quarter of

1983, shows a plus 2.3 percent. If you compare that with the first quarter of 1982 on the same basis, it showed a minus 1.1.

The increase in unit labor costs, again citing the year ending in the first quarter, is only 3.6 percent. Take that back to first quarter of 1981 and you get a 9.9 rise in unit labor costs. So certainly the productivity figures are encouraging.

Now, unfortunately, much of the gain in productivity is, of course, due to a short work week and a widespread curtailment in the use of labor. The question is going to be, now that demand is rising and the work week is lengthening, will productivity hold?

My guess is that it will hold for some period of time, because the flip side of this awful rate of unemployment and underemployment that you are rightly concerned with—and we are—is, of course, you get higher productivity, and that makes a given occupation and a given industry more competitive, more competitive particularly in the international area. If we could get back a couple of million of those jobs in export agriculture, export industry, export services, it would be so useful to all of us.

Mr. CARPER. One last question, if I could. Will you just trace briefly for us the history of real interest rates, and I mean very briefly. Also, take a close look, if you would, at real interest rates over the course of, say, the last 12 months.

Why are they staying so high? What can we do collectively to bring them down?

Mr. MARTIN. If I may, I will submit the data to you with regard to month-by-month interest rates over that period of time. To be responsive to your question, real interest rates have stayed stubbornly high over the period of time that you have indicated. This is particularly a function of the fact that most price indexes have been coming down so much; that although interest rates have had some decrease up until the last few weeks, prices have fallen faster. There appears to be some doubt, particularly in long-term markets, that inflation will stay at these recent low rates.

So we have a real interest rate that is a burden on the recovery and one in which there are very few historical precedents for in this country. There are a number of factors involved, and there is a degree in which we don't know everything there is to know about real interest rates.

Certainly, one major factor is the expectation of out year mega-deficits colliding with the need to finance equipment, plant, inventory, receivables, and overseas trade. If you are a portfolio manager buying 5- and 10-year obligations, you are going to require the borrower to pay 12 or 13 percent, because you feel like inflation is going to be back up there when that obligation comes due.

Or 3 or 4 years down the road when you have got to explain to your board of directors why you are getting such a poor return on those investments. It is expectational in large part.

Mr. CARPER. Mr. Martin, Mr. Keehn, thank you both very much for your appearance and testimony today.

[In response to the above question of Congressman Carper, the following letter was sent by Mr. Martin containing the requested data:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

PRESTON MARTIN
VICE CHAIRMAN

July 27, 1983

The Honorable Thomas R. Carper
House of Representatives
Washington, D. C. 20515

Dear Mr. Carper:

I am pleased to submit the enclosed material in response to your question during the hearing on June 1 before the Subcommittee on Domestic Monetary Policy concerning the level of real interest rates over the last 12 months.

As you are aware, several pitfalls exist to arriving at a specific determination of the real rate of interest for any given period of time. The most obvious of these relates to the selection of the appropriate nominal interest rate and an inflation index for analysis from the wide variety of such indicators available. From the perspective of assessing the most current real interest rate levels, an additional problem exists in that real interest rates may be regarded as a measure of current nominal rates, that are observable in credit markets, less expected inflation rates that are not. For these reasons I have provided alternative measures of real rates over the last 12 months for your review. Also enclosed are data on the movement of real rates over a broader period, 1959-83.

Please let me know if I can be of further assistance.

Sincerely,

Preston Martin

Preston Martin

Enclosures

Ten Year Treasury Bond Less 36 Month Moving Average of CPI

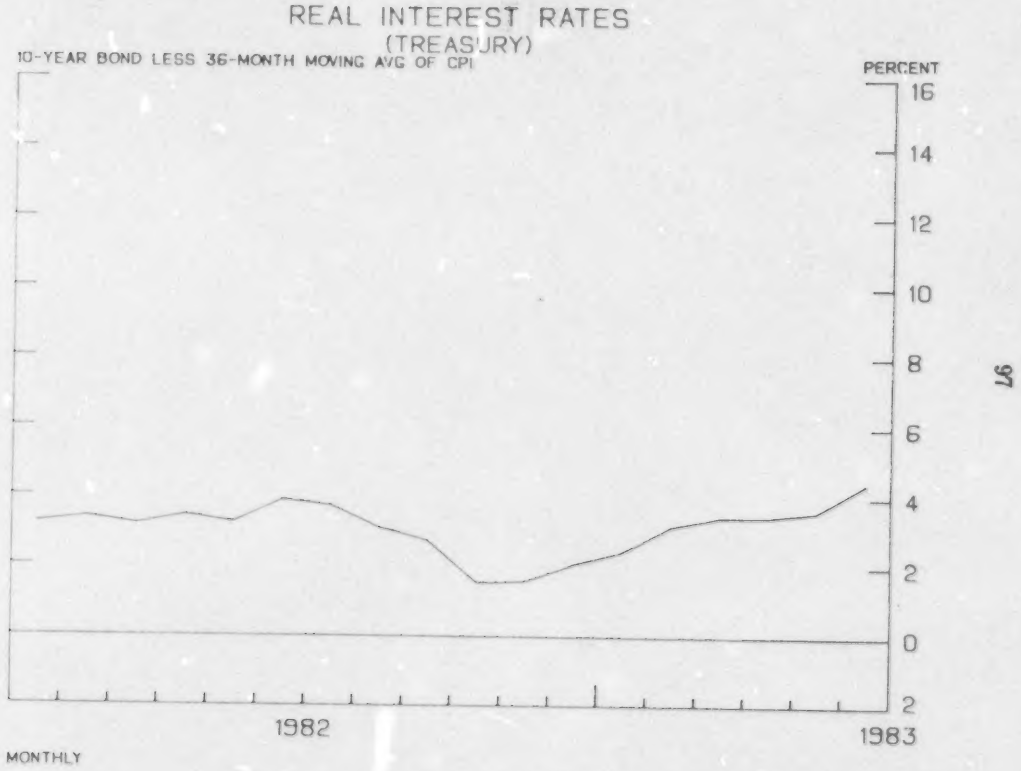
	10 year Treasury Bond	36 month moving avg of CPI	Real Rate
1982-JAN...	14.59	11.39	3.21
-FEB...	14.43	11.05	3.37
-MAR...	13.86	10.70	3.16
-APR...	13.87	10.45	3.42
-MAY...	13.62	10.41	3.22
-JUN...	14.30	10.43	3.87
-JUL...	13.95	10.23	3.71
-AUG...	13.05	9.97	3.09
-SEP...	12.34	9.61	2.72
-OCT...	10.91	9.37	1.53
-NOV...	10.55	8.96	1.59
-DEC...	10.54	8.47	2.07
1983-JAN...	10.46	8.03	2.43
-FEB...	10.72	7.57	3.16
-MAR...	10.51	7.08	3.43
-APR...	10.40	6.96	3.44
-MAY...	10.38	6.79	3.59
-JUN...	10.85	6.43	4.42

Three Month Treasury Bill Less 12 Month Moving Average of CPI

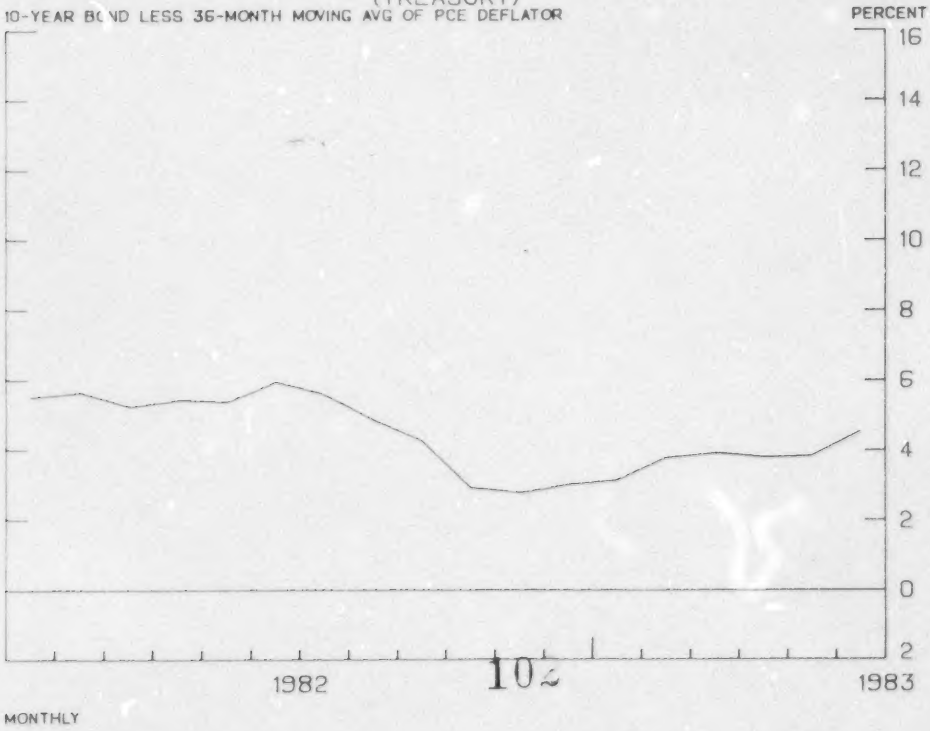
	3 month Treasury Bill	12 month moving avg of CPI	Real Rate
1982-JAN...	12.28	8.48	3.80
-FEB...	13.48	7.75	5.73
-MAR...	12.68	6.88	5.80
-APR...	12.70	6.71	6.00
-MAY...	12.09	6.88	5.21
-JUN...	12.47	7.21	5.25
-JUL...	11.35	6.60	4.75
-AUG...	8.68	6.03	2.65
-SEP...	7.92	5.06	2.86
-OCT...	7.71	5.12	2.59
-NOV...	8.07	4.64	3.42
-DEC...	7.94	3.97	3.96
1983-JAN...	7.86	3.86	4.00
-FEB...	8.11	3.59	4.53
-MAR...	8.35	3.76	4.59
-APR...	8.21	4.11	4.11
-MAY...	8.19	3.58	4.61
-JUN...	8.79	2.44	6.36

Three Month Treasury Bill Less Contemporaneous CPI

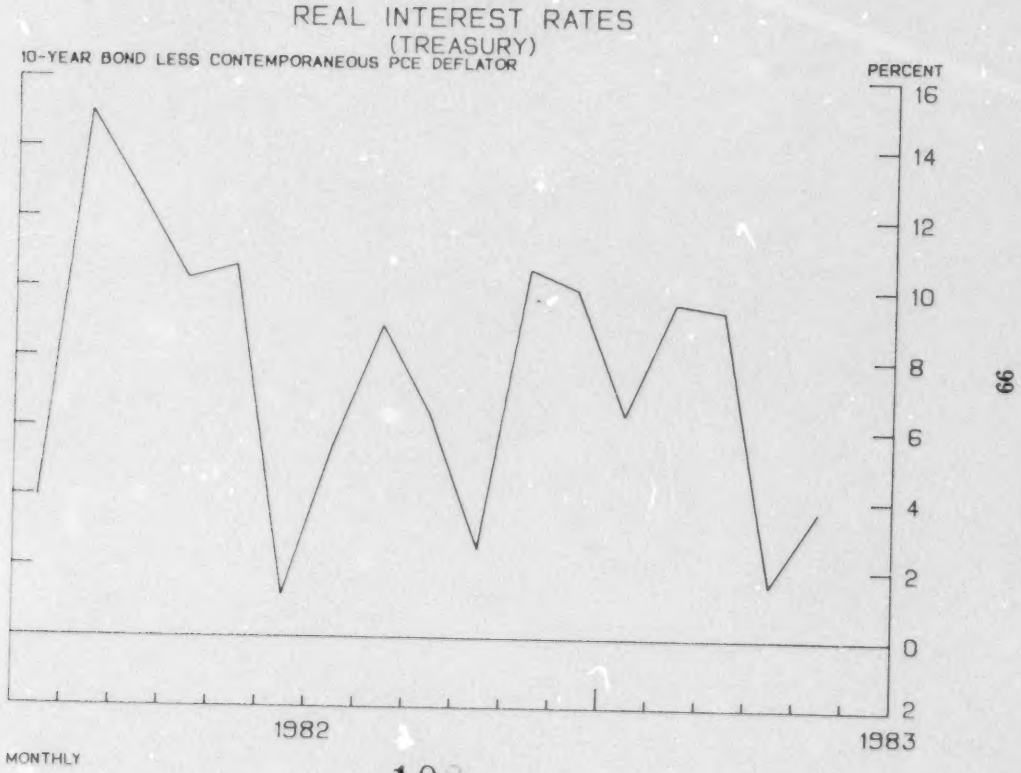
	3 month Treasury Bill	CPI	Real Rate
1982-JAN...	12.28	3.45	8.82
-FEB...	13.48	0.85	12.63
-MAR...	12.68	-0.42	13.10
-APR...	12.70	3.00	9.70
-MAY...	12.09	12.96	-0.88
-JUN...	12.47	13.77	-1.30
-JUL...	11.35	7.26	4.08
-AUG...	8.68	3.77	4.91
-SEP...	7.92	1.24	6.68
-OCT...	7.71	5.03	2.68
-NOV...	8.07	0.0	8.07
-DEC...	7.94	-3.22	11.15
1983-JAN...	7.86	2.06	5.79
-FEB...	8.11	-2.42	10.54
-MAR...	8.35	1.65	6.70
-APR...	8.21	7.17	1.04
-MAY...	8.19	6.70	1.49


REAL INTEREST RATES
(TREASURY)
10-YEAR BOND LESS 36-MONTH MOVING AVG OF CPI
PERCENT
16
14
12
10
8
6
4
2
0
2
1982
1983
MONTHLY

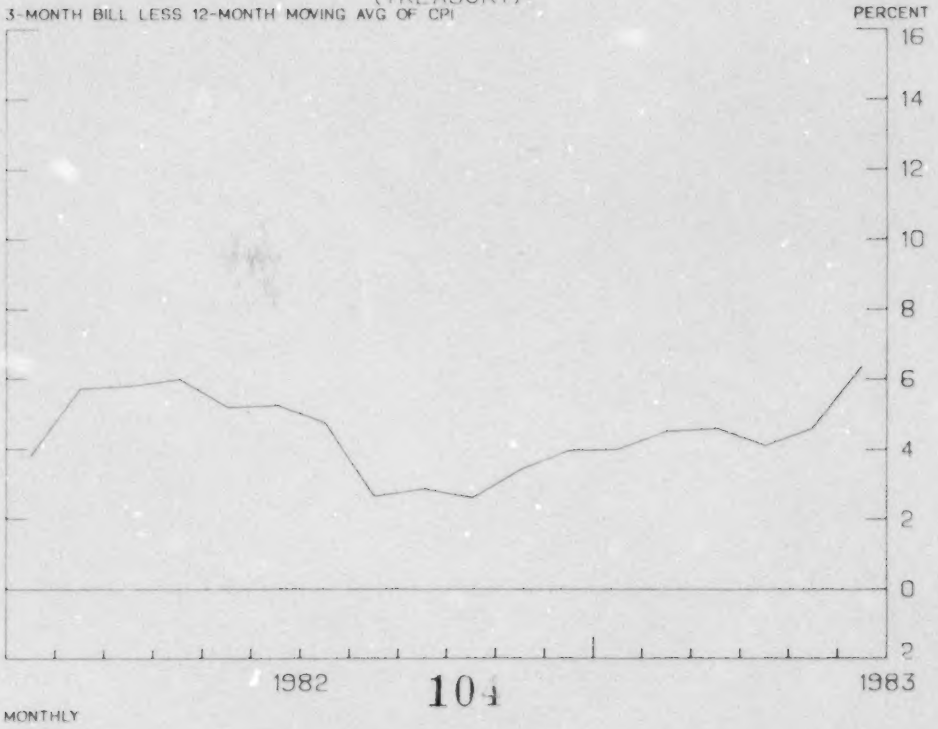
REAL INTEREST RATES
(TREASURY)



86

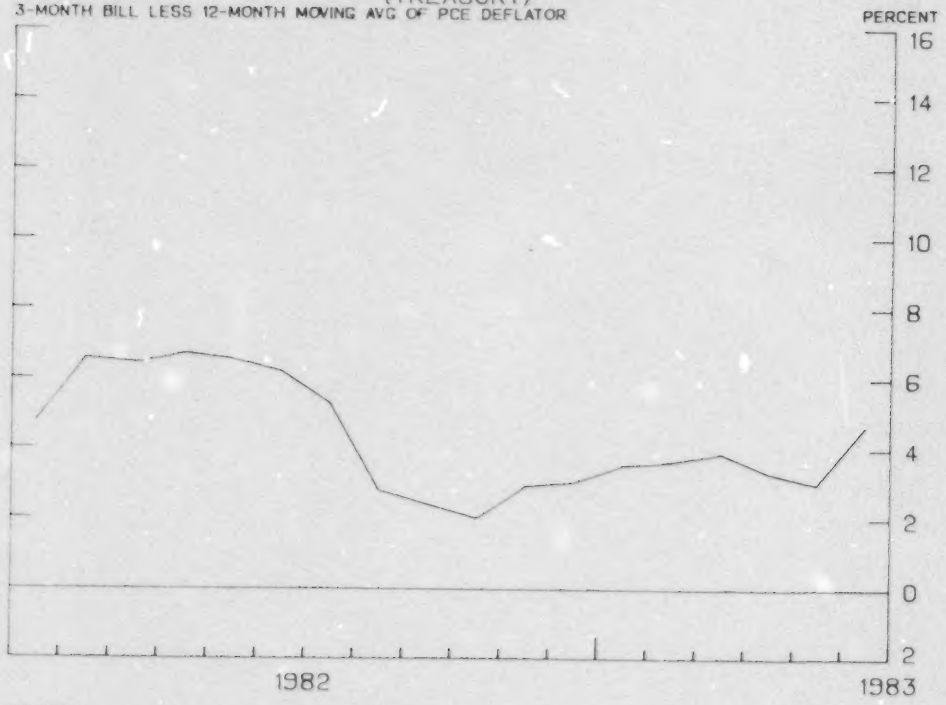

REAL INTEREST RATES
(TREASURY)
10-YEAR BOND LESS CONTEMPORANEOUS PCE DEFLATOR
PERCENT
16
14
12
10
8
6
4
2
0
2
1982
1983
MONTHLY
99
66

REAL INTEREST RATES
(TREASURY)

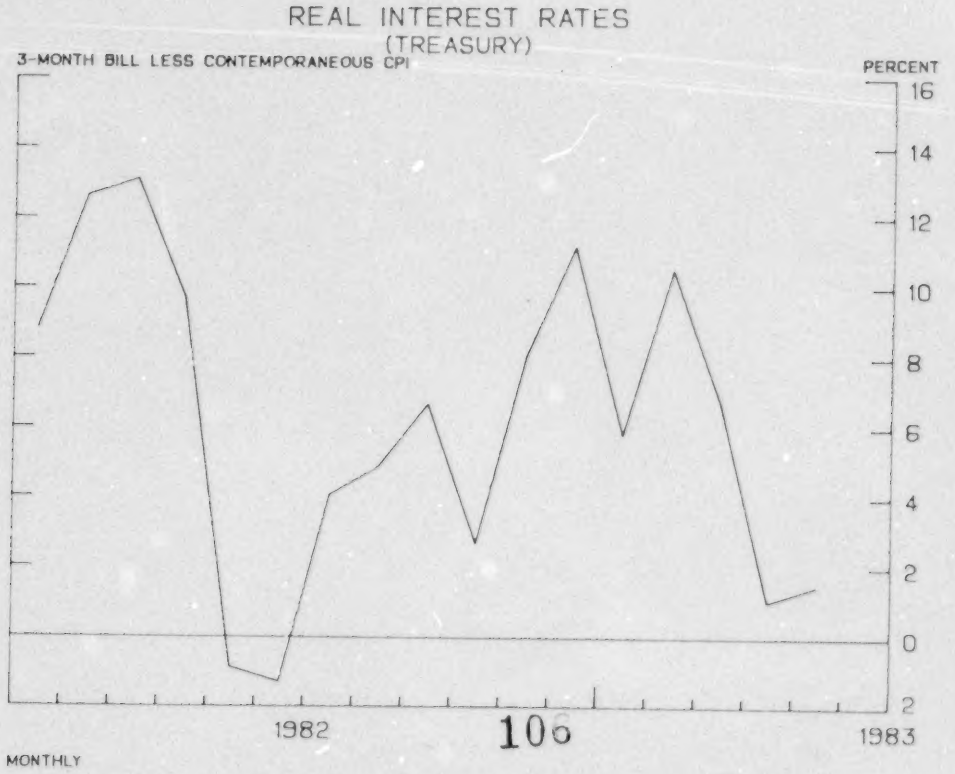


100

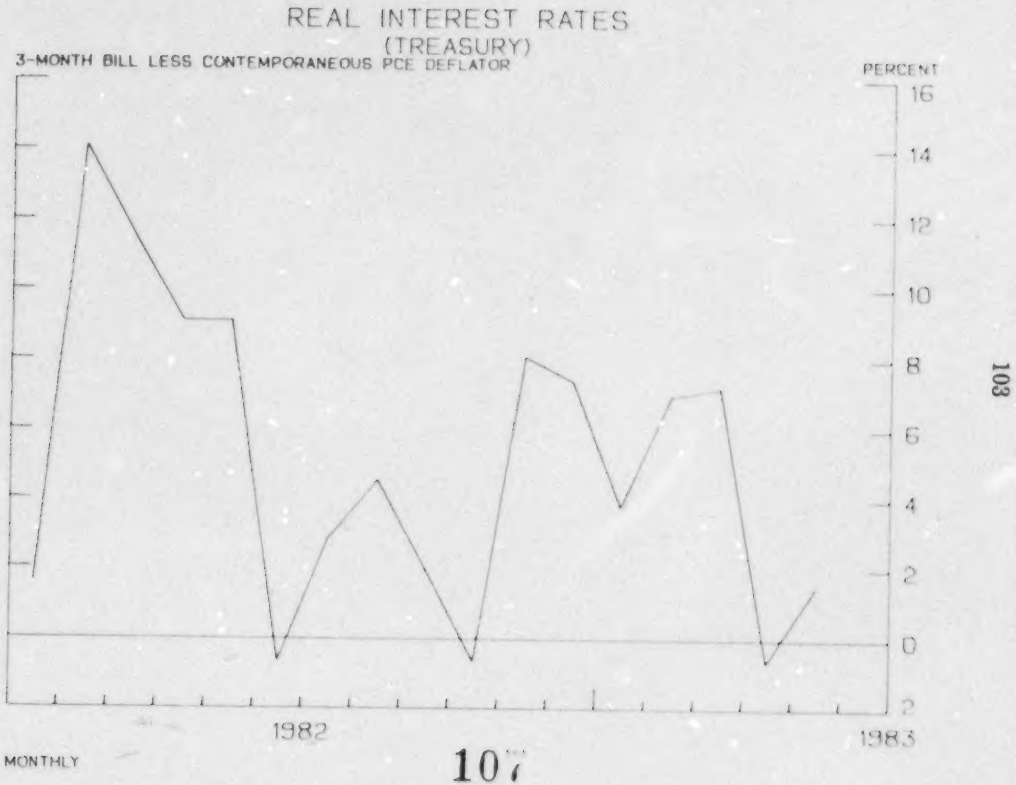
REAL INTEREST RATES
(TREASURY)

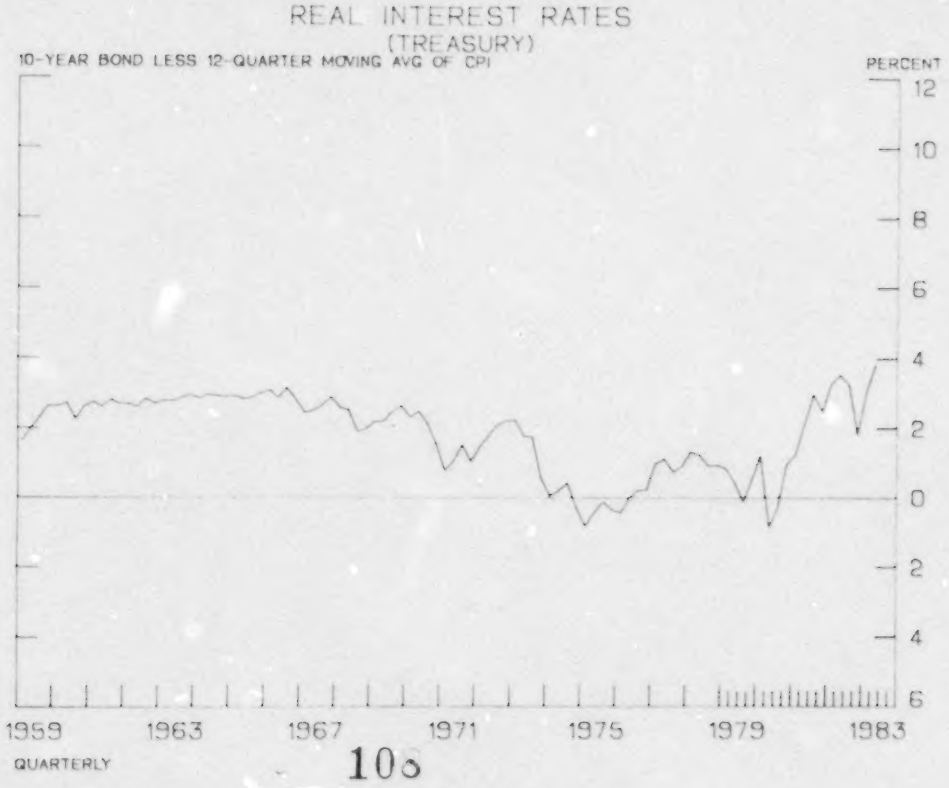


101

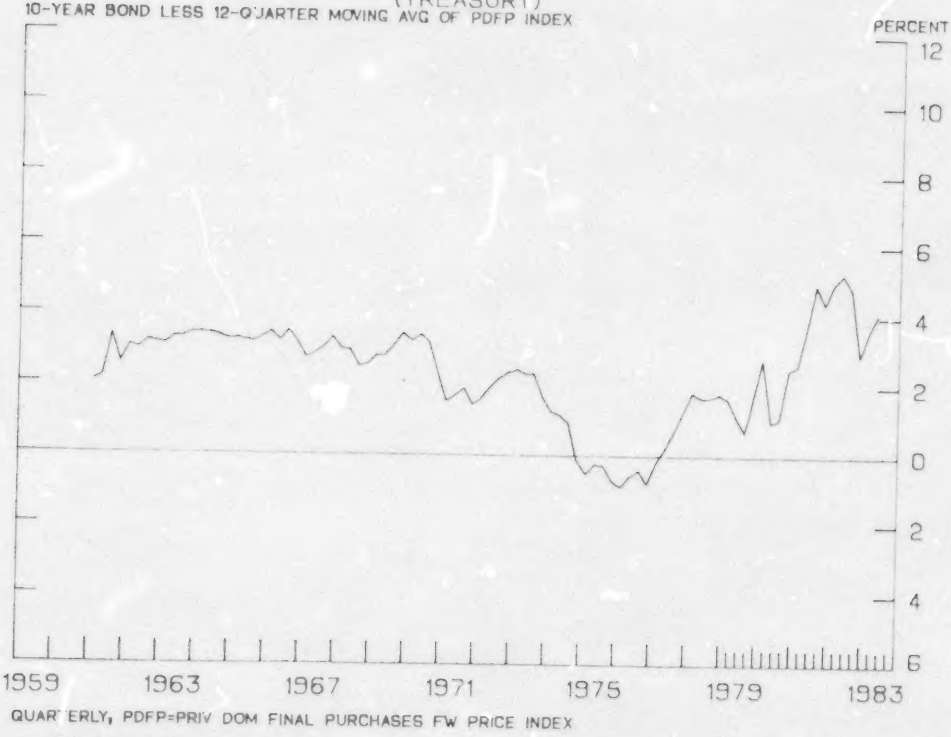

REAL INTEREST RATES
(TREASURY)
3-MONTH BILL LESS CONTEMPORANEOUS CPI
PERCENT
16
14
12
10
8
6
4
2
0
2
1982
1983
MONTHLY

102


REAL INTEREST RATES
(TREASURY)
3-MONTH BILL LESS CONTEMPORANEOUS PCE DEFLATOR
PERCENT
16
14
12
10
8
6
4
2
0
2
1982
1983
MONTHLY

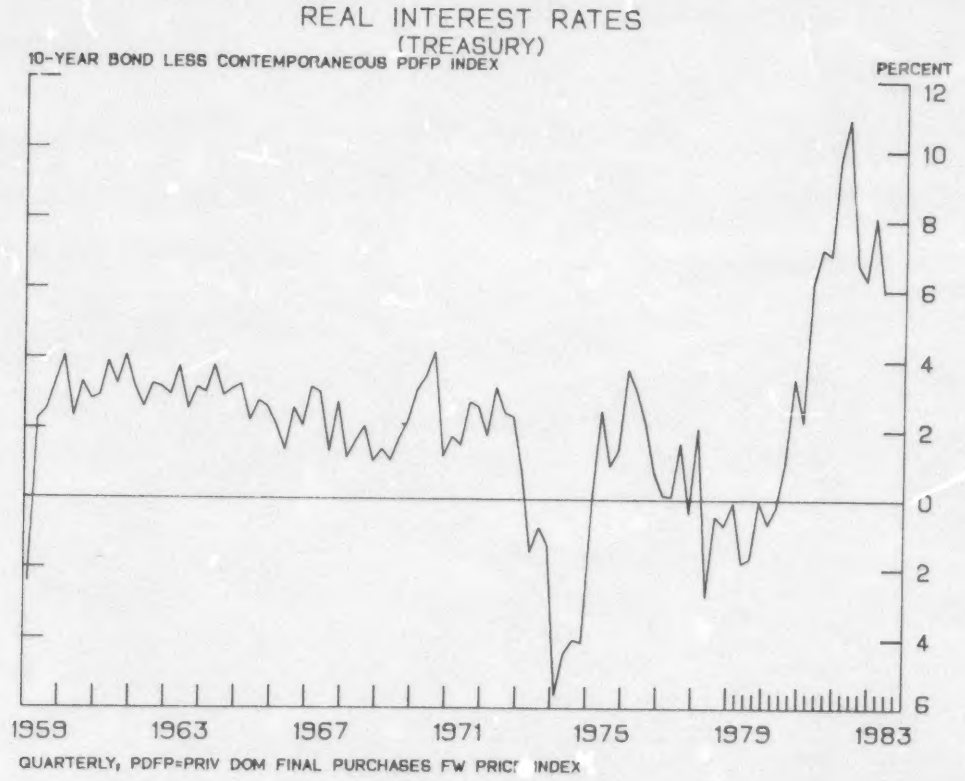

REAL INTEREST RATES
(TREASURY)
10-YEAR BOND LESS 12-QUARTER MOVING AVG OF CPI
PERCENT
12
10
8
6
4
2
0
2
4
6
1959
1963
1967
1971
1975
1979
1983
QUARTERLY

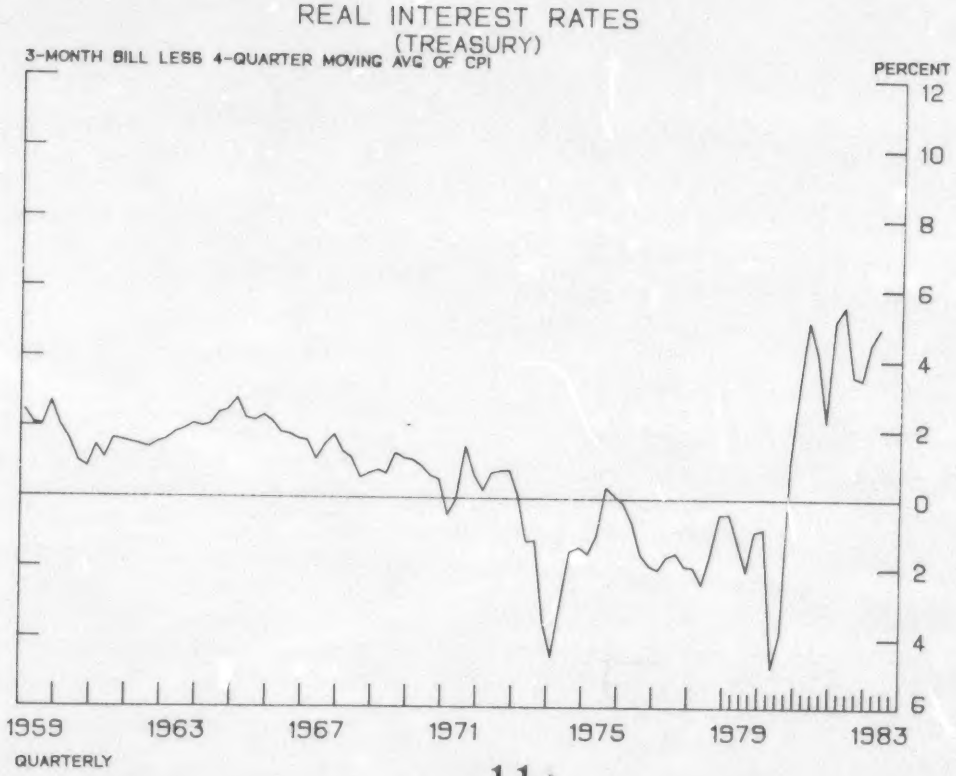
REAL INTEREST RATES
(TREASURY)



QUARTERLY, PDFP=PRIV DOM FINAL PURCHASES FW PRICE INDEX

105


REAL INTEREST RATES
(TREASURY)
10-YEAR BOND LESS CONTEMPORANEOUS PDFP INDEX
PERCENT
12
10
8
6
4
2
0
2
4
6
1959
1963
1967
1971
1975
1979
1983
QUARTERLY, PDFP=PRIV DOM FINAL PURCHASES FW PRICE INDEX


REAL INTEREST RATES
(TREASURY)
3-MONTH BILL LESS 4-QUARTER MOVING AVG OF CPI
PERCENT
12
10
8
6
4
2
0
2
4
6
1959
1963
1967
1971
1975
1979
1983
QUARTERLY

Chairman FAUNTROY. Mr. Martin, on a related matter, yesterday the stock markets fell 16 points, apparently because investors believe that the current above target M1 growth would force the Fed to tighten and send interest rates up. A week or so ago you said that the Fed would continue to pay less attention to M1 than to M2 and to M3. In light of that statement, do you think that the market is overreacting to the M1 growth? In your view, is it necessary to tighten monetary policy in order to bring down the M1 growth?

Mr. MARTIN. Let me answer the second question first, if I may. I think it may be helpful to do it that way.

We are still looking forward to the completion of the kinds of adjustments in the holding of money and near monies kinds of assets that we have seen in the M2 and M3. After all, rates of growth in those two broader aggregates were very much higher just a few months ago.

We have had some relief in M1. But the question is, How long will it hold? And some relief still leaves you way above the upper line of the curve as far as that aggregate is concerned. I don't mean to imply we are ignoring M1. We can't.

There is still enough of a relationship between the growth in nominal gross product over time and M1, even when it is behaving in such an erratic way, up one month, down another, so that one cannot ignore M1. But the more basic considerations are still furthering the recovery, the strength of that recovery, and what indicators are there that inflation is coming back.

I hope I have been candid and of some use to you in your thinking to indicate that it looks as though the recovery is a little stronger, but it doesn't look like inflation is coming back. It seems to me it is more important to watch the inflationary leading indicators than it is purely the M1. But one can't ignore it.

I guess in sum, it is one of several factors we have to consider. But we shouldn't be governed by it alone.

Chairman FAUNTROY. Gentlemen, I want to thank you so very much for your thorough and provocative testimony. We have all benefited from it, and I am sure that the committee and the public at large is in your debt for the time and energy you have committed to preparation for today.

Thank you so very much.

With that, the hearing will come to a close.

[Whereupon, at 4:05 p.m., the subcommittee adjourned subject to the call of the Chair.]

[The following article "What Is 'Full Employment'?" was submitted by the subcommittee for inclusion in the record:]

What Is 'Full Employment'?

In the 1960s, it was a 4% jobless rate. Today, some experts say it's 7% or higher. What level the voters ultimately tolerate has profound implications for the inflation rate and the future of the GOP.

Full employment, which has been a long-time national goal under both Democratic and Republican Administrations, seems to be a distant target these days. But even before this relentless recession sent the nation's jobless rate to a 41-year high of 10.8%, the experts were sharply divided as to what level of unemployment—5%, 6%, 7% or higher—constitutes "full" employment in a complex, rapidly changing economy in which many of the old benchmarks are no longer valid.

Moreover, for the first time in two decades, the President's Council of Economic Advisers considered dropping the whole concept of full employment in its 1983 Economic Report. "Identifying a number that you can call full employment is awkward and puts you into a fuzzy never-never land," maintains CEA member William Poole. The time-honored way of using such a figure to calculate potential Gross National Product "sets unreasonable GNP targets that lead to policy mistakes," he adds.

This is a far cry from the early 1960s, when CEA analysts invented and perfected the concept of a full employment budget that indicated what GNP and federal revenues would be if joblessness was at 4%, which was generally considered to be full employment. In those halcyon days of 1%-to-2% inflation, the economy performed remarkably well at a 4% jobless rate.

But the world has changed and most experts, both liberal and conservative, agree that the 4% yardstick is no longer valid. This is due to such factors as the profound changes in the makeup of the labor force, including

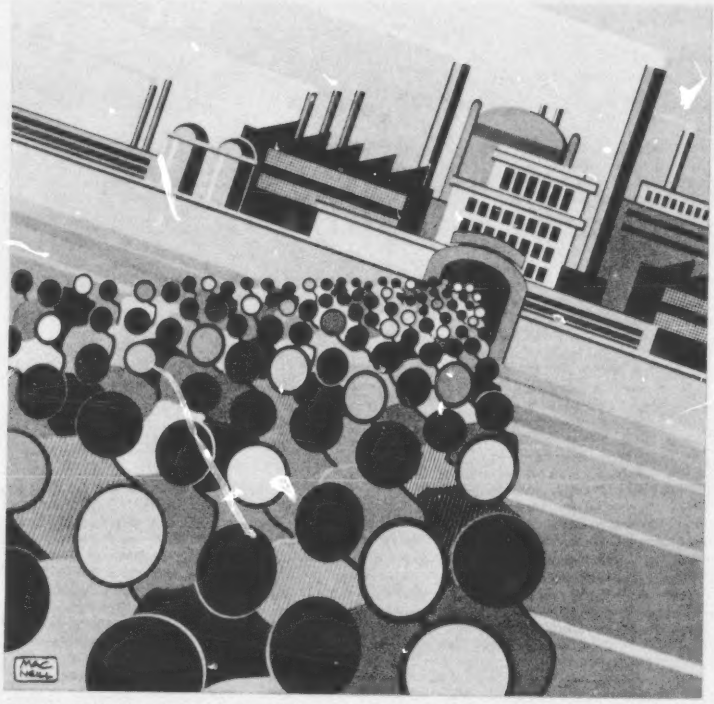
Labor force changes

the massive entry of women and unskilled teenagers; the dismaying decline of heavy industry; the rapid growth of high-technology firms that demand new skills; the geographic shift of plants and capital out of the Frost Belt to the Sun Belt; and the phenomenon of the underground economy, which employs untold numbers of people off-the-books.

About 6%-to-7% unemployment is the best that can be hoped for, in the opinion of Martin Feldstein, chairman of the CEA, who believes that a lower rate would set off another inflationary spiral. What's more, he sees little hope that the nation will get down to his version of full employment during the next five years, even if there's a prolonged period of growth that wipes out the top layers of "cyclical" joblessness caused by recession alone.

To understand why, says University of Minnesota economist Walter Heller, think of unemployment as if it were a layer cake. "There's an absolutely irreducible minimum at the bottom—about 3%—that simply results from normal movement from job to job," he explains. This so-called "frictional" and seasonal unemployment exists no matter what the economy is doing, explains Heller, who was top White House economist in the Kennedy and Johnson Administrations.

Indeed, as the demographic makeup of the work force has changed, many analysts have concluded that the lowest natural level of frictional unemployment has risen to 5% or 5.5%. The reasoning is that women and



young, inexperienced workers have poured into the job market—and these new entrants are deemed more likely to move in and out of work. Not all economists buy this, however. "It's a sexist view, and I'm amazed at the number of people who cite it," says Harvard University labor expert Quinn Mills.

The second layer of unemployment is dubbed "structural" and has nothing to do with the business cycle. A big percentage of current joblessness, in some analysts' view, is due to structural factors that won't be affected by an upturn in the economy. "These are people who can't find work even in a prosperous economy," adds Heller.

A variety of mismatches between job-seekers and the jobs that are offered is the reason structural unemployment appears to be growing, says Conference Board economist Audrey Freedman. She believes the biggest problem is a growing skills mismatch: hundreds of thousands of blue-collar workers who have been laid off in shrinking industries such as autos and steel don't have the training for hi-tech jobs. "Plenty of companies are looking for atomic-tube welders, but they can't use auto welders," Freedman notes.

Other structural mismatches are geographical: the new factories are in Houston, the jobless workers are in Detroit. Often, there's a dichotomy between the wages workers from Michigan expect and the rates Texas' employers are willing or able to pay. Still other factors drying up jobs are minimum wage laws and union contracts, which raise the price of labor beyond what a job may be worth. Discrimination plays a part as well, says Freedman. "Some bosses want a thirty-year-old white male, and the only applicants they get are female, black or over 55," she points out.

If about 3% unemployment is the rock-bottom natural level that can't be avoided, and another 2.5% can be blamed on sheer demographics, then how much of today's 10.8% joblessness is caused by structural factors and how much is simply the result of a severe recession? "We really don't know what the proportions are," contends Heller. But he leans toward the view that a lot of joblessness that ap-

pears to be structural could be ameliorated by a strong recovery. "All kinds of things that could be solved by a pick-up in demand look like part of a long-term trend after the four years of stagnation we have had," he says.

Jason Benderly, chief economist of The Prudential Insurance Co., sees it this way: "The composition of the work force takes full employment up to 5.5% and structural changes gets it up to 6.5%." And he adds, because unemployment compensation and other jobless benefits reduce the urge to find work, full employment is now probably 7%-to-7.5%. "I'm not saying that everyone is voluntarily unemployed," he emphasizes. "But these payments have a definite impact."

His point is underscored by Chairman Donald Clem of McConway and Torley Corp., a foundry operation. "When we were expanding in Pittsburgh, a neighboring plant was closing its doors and 1,000 workers lost their

High jobless pay

jobs. But we were unable to attract even a single one of these skilled people," he recalls. Clem is convinced the reason was high unemployment compensation. "Unfortunately, when their benefits ran out, we were no longer hiring," he adds.

High unemployment benefits are not the only "institutional barrier" to a lower level of full employment. The high relative wages of many U.S. workers are a major reason why the nation's economy is not adjusting more rapidly to the threat of foreign competition, according to economist Marvin Kosters of the American Enterprise Institute. "There's nothing wrong with our auto workers that a 30% wage cut wouldn't cure," he says. "That sounds harsh, but it's true." Jason Benderly agrees that, because of the wage differential between U.S. and foreign autoworkers, 400,000 Americans will never again find work making cars.

Yet, both Benderly and Kosters admit, it's extremely unlikely any fast action will be taken on such deeply embedded institutions. "Given the laws and wage structure we have today, there's no way we can move quickly toward even a 7% level of full employment," Benderly says. He agrees with Feldstein that it will take at least five years—and that's assuming steady economic growth.

Such talk is shocking to labor leaders and liberal economists. "No other economy in the world would accept those numbers," says AFL-CIO economist John Zalusky. "This level of unemployment is a terrible waste of human resources, and the Reagan Administration is making a fatal mistake if it believes the American public will settle for 7%." Harvard's Quinn Mills is equally outraged: "I don't buy any of those numbers," he says. "Unemployment should be no more than 3%, period." To accept 7% as full employment, Mills maintains, is "to beg the purpose of what the economy is all about—which is to provide people with jobs."

As the 1984 Presidential sweepstakes get closer and closer, the economics of the full employment issue will surely take a back seat to the politics of the problem. When 1984 dawns, the jobless rate will probably still be more than 10%. And, as the Democrats inevitably pounce on the Reagan Administration's dismal record in producing jobs, the question of what constitutes full employment will no longer be academic. This has convinced many political insiders that hasty action aimed at reducing double-digit joblessness is inevitable. "If Reagan doesn't make a move soon, Congress will start engineering things," says a worried White House aide.

However, any White House urge to act will be seriously tempered by fear of rekindling inflation. "We are so far away from full employment that any attempt to achieve it quickly is bound to be inflationary," says Benderly, who believes the recent easing of monetary policy has already increased the risk that the Consumer Price Index could be back up to 8% by mid-1984. He estimates that it would take 12% real GNP growth to get the jobless rate down to 7% in one year; 7.5% real growth to accomplish that

goal in two years; and 6% steady growth to do it in three years. "That's pretty well outside the bounds of reality," Benderly comments. "And it would have to be done at the expense of stable prices."

Until the inflation war is conclusively won, many analysts believe that Reagan—and the Federal Reserve Board—will ask Americans to keep paying the high-unemployment cost of the battle. "The bottom line is that policymakers don't really know how to

The bottom line

reduce inflation and get full employment at the same time. It's never been done," says Benderly.

Walter Heller, for one, questions that this tradeoff is either necessary or inevitable. He notes that during the early 1960s, when he was top White House economist, unemployment was 4% and inflation was 1.2%. "We had a combination of measured expansion, a monetary policy that could accommodate that expansion, and fairly effective wage-price guideposts," he says. Heller admits he had a better starting point than the Reagan Administration faced because inflation was near zero after the Eisenhower years. "But when the economy is this weak, the risks of expansion are small—and the rewards are great," he argues. "The White House is being much too timid in its policies."

Some analysts feel it's too late for the traditional expansionary measures Heller proposes. "It took World War II to get us out of the Great Depression, and we must launch the peacetime equivalent to get us out of this one," says Quinn Mills. It wouldn't surprise Mills if President Reagan went on television in a few months to announce a sweeping "Put America Back to Work" plan to create jobs.

With a federal budget deficit of $200 billion looming, such an expensive idea horrifies moderate and conservative economists. "But the situation is no longer a spending problem. It's the revenue side that has collapsed," Mills contends. When capital investment is plunging, foreign trade is collapsing and consumers are either unemployed or scared they will be, he says, it's no time to worry unduly about budgetary red ink.

A seasoned CEA staffer thinks it will be Congress, not the White House, that proposes some form of national reconstruction program. "Unless the recovery reduces the unemployment rate much more than expected, schemes to manage trade, promote industrial growth and bail out losers will be the order of the day," he predicts. The greatest danger, this economist adds, is that, responding to constituent pressures, a protectionist fever will sweep Capitol Hill. "It could be a real disaster for world trade."

The Reagan Administration is resisting such initiatives and hopes that the passage last year of the measure to finance a road repair program by raising the gasoline tax by 5 cents a gallon, which could create about 320,000 jobs, and the Jobs Training Partnership to replace the Comprehensive Employment and Training Act, will ease the pressure for more jobs programs. But given the level of unemployment and the Democratic gain of 26 House seats, most observers expect a raft of new jobs proposals to be introduced, including a massive public works program to rebuild the

Eyeing 1984

nation's crumbling infrastructure. With an eye towards the 1984 elections, many Republicans could support such a measure. And it is not inconceivable that, in the end, the White House could cave in to the political pressure.

In the meantime, short of an all-out assault on joblessness, there's little hope that even a 7% jobless rate can be attained until the latter part of the decade. It's hard to believe that the American public will either accept that number as the best that can be expected—or wait until 1987 to attain it. If they hope to stay in office, Republicans will have to come up with a better alternative than a slow, painful crawl toward the most dismal definition of full employment the nation has ever known. —MARILYN WILSON